Bank of Albania

FINANCIAL STABILITY REPORT 2011 H2

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PREFACE

This is the seventh issue of the Bank of Albania's Financial Stability Report, which is produced half-yearly. The purpose of this Report is to detect and assess the risks facing the financial system and its infrastructure, in order to provide the public authorities with the opportunity to identify relevant measures for the necessary adjustments. The Report is opened with the Financial Stability Statement, whose half-yearly release is a legal requirement.

In producing this Report, we have used data available at the Bank of Albania, and information has been exchanged with other authorities supervising the financial market activity. We have also used information and analyses of public and private, national and international financial institutions. The data and analyses cover mainly the developments over 2011 H2. Unless otherwise stated, the expectations on the economic and financial outlook generally extend until end-2012.

The financial system stability has been assessed on the basis of the performance and risks arising from its interaction with the overall internal and external economic environment, as well as from its activity. In order to assess the risks arising from its interaction with the surrounding environment, we have analysed the latest developments in the international financial markets, and in advanced and regional economies. We have also assessed their impact on the Albanian financial system and banking sector. As far as domestic indicators are concerned, the present Report makes an assessment of the overall developments and expectations for economic growth, balance of trade, overall price level, exchange rate and fiscal indicators. The analysis focuses on the assessment of the situation, performance and risks of the banking sector, as the dominant segment of the financial system in Albania. In addition, by making an analysis of employment and income, it provides an assessment of businesses and households' financial situation and impact on the banking sector borrowers' solvency.

NOTES

As at end-December 2011, the banks operating in Albania were divided into the following groups by their share:

a) Banks Peer Group 1 (each sharing 0-2% of total banking sector's assets): United Bank of Albania, Veneto Bank, International Commercial Bank, First Investment Bank, Credit Bank of Albania;

b) Banks Peer Group 2 (each sharing 2-7% of total banking sector's assets): ProCredit Bank, Emporiki Bank, Branch of National Bank of Greece, Société Générale Bank-Albania, Alpha Bank-Albania, Union Bank;

c) Banks Peer Group 3 (each sharing over 7% of total banking sector's assets): Raiffeisen Bank, Credins Bank, National Commercial Bank, Intesa Sanpaolo Bank-Albania, Tirana Bank.

As at end-December 2011, by capital origin[1], the banks operating in Albania were divided as follows:

a) Austrian-owned banks: Raiffeisen Bank;

b) Italian-owned banks: Intesa Sanpaolo Bank-Albania, Veneto Bank;

c) Greek-owned banks: Alpha Bank-Albania, Tirana Bank, Branch of National Bank of Greece;

d) French-owned banks: Société Générale Bank-Albania, Emporiki Bank;

e) Albanian-owned banks: Credins Bank, Union Bank.

As at end-December 2011, by form of establishment, the branches[2] of the Albanian banking sector banks were as follows: Alpha Bank-Albania, Branch of National Bank of Greece. The following banks are also evidenced to have extended their branch network abroad: National Commercial Bank and Intesa Sanpaolo Bank-Albania, respectively in Prizren, Kosovo and Athens, Greece.

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[1] *By capital origin, when foreign capital accounts for more than 50% of bank's paid-in capital.*

[2] *The process of transforming branches into foreign bank subsidiaries will be completed in the first half of 2012.*

FINANCIAL STABILITY STATEMENT FOR 2011 H2

Pursuant to the provisions stipulated under Article 69 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of the Law No. 9962, dated 18 December 2006 "On Banks in the Republic of Albania", as amended, to inform the Parliament of the Republic of Albania and the Council of Ministers, and to draw the attention of financial institutions and the public at large on the situation of the Albanian financial system and the potential risks that may jeopardize its stability, the Bank of Albania releases the following periodical statement, which is an integral part of the Financial Stability Report for the same stated period.

The Bank of Albania assesses that the financial system and banking sector's situation and performance remain stable. Capitalisation and liquidity figures of the banking sector's activity are at satisfactory levels; however, its capacity to generate sufficient income remains concentrated in individual banks. Banking sector exposure to direct market risks is at low levels, while direct and indirect credit risk represents the main challenge facing the banking sector activity. Developments in the surrounding internal and external economic environment, and households and businesses' financial situation are assessed as being in line with their medium-term performance. The following elaborates on the interaction of the financial system with the economic environment and exposure to various risks.

Global economy decelerated its growth rates in 2011 H2, particularly owing to the performance of advanced economies. The uncertainties heightened due to the severe sovereign debt crisis in the euro area. On average, global economic growth decelerated to 3.8% in 2011, compared to 5.2% in 2010. Advanced economies expanded by 1.6%, as a result of the unstable financial situation in the euro area, sluggish bank lending to the real economy and the curbing effect of fiscal consolidation process on economic growth. Emerging and developing economies grew by 6.2%, still lower than in 2010. Global growth is anticipated to slow down further in 2012, with advanced economies expected to expand by 1.2%, and emerging and developing economies by 5.4%.

In the euro area, economic activity decelerated as a result of the lower consumer spending and sluggish domestic demand in the large block countries. Unemployment rate rose to 10.4% at end-2011, while the inflationary pressures subsided. Fiscal consolidation remains the main challenge for the euro area countries, therefore, a number of them, such as Italy, Spain and France, have announced measures to reduce the high accumulated debt further and boost economic growth.

Economic activity in Central and Eastern Europe recovered in the second half of the year; however, the growth rates were not uniform across the countries. In Bulgaria, the Czech Republic and Slovakia, economic growth rates slowed down in 2011 Q3 compared to the previous periods, mainly due to the fall of external demand and weaker investment. Growth in countries like Poland and Romania continued to be fairly buoyant, driven mostly by domestic demand. In the Balkans, Turkey and FYROM posted higher growth rates.

On the other hand, growth in the United States accelerated in 2011 H2, driven by the improved private investment, consumer spending and net exports. Growth, however, slowed down to 1.7% y-o-y in 2011, from 3% in 2010. The real estate market continued to perform sluggishly, while the unemployment rate fell in the last quarter of 2011, ending the year at 8.5%.

During the period under review, the performance of the global financial markets reflected the difficulties facing the global economy and economic agents. The euro area money markets were highly volatile and the interest rates were upward. In order to relieve the pressures, the European Central Bank employed different financial instruments to increase liquidity in the market, and cut the key policy rate twice by 25 basis points each in November and December, respectively, to 1%. Despite these measures, overall, the trading volumes in the interbank market remained low in 2011 Q4 and the risk premiums increased higher than in the other markets, reflecting the higher counterparty risk among financial institutions and banks. In the debt securities markets, the pressures for the increase of yields were fairly high, particularly for high-debt countries such as Italy, Spain and France. In stock markets, investors continued to be reluctant to purchase corporate shares and bonds. As a result, the funding cost through them grew higher and the performance of prices in the major stock markets was unstable. In the foreign exchange markets, investors turned to safer currencies, such as the Japanese yen and the Swiss franc. Against this setting, throughout 2011 H2, the Euro has generally been unstable against the other major currencies. In primary commodity markets, the prices were generally downward due to the sluggish global demand. Oil price, however, rose at end-2011, mainly owing to supply-side developments and heightened geopolitical risk in oil-producing countries.

Profitability indicators for Global Large and Complex Banking Groups were relatively stable. The low interest rates and the sluggish credit growth reflected in a considerable decline of interest income in some of the banks. Concerning euro area banking groups, their financial performance deteriorated during 2011 H2, mainly due to the higher provisioning against credit risk and the sharp decline of trading income. In October 2011, the European Banking Authority conducted an EU-wide stress testing exercise, which evidenced the need for the European banks to raise an extra EUR 114.7 billion in new capital. For the period ahead, the uncertainty surrounding the future outlook of the securities market in the euro area will continue to remain high and the risk of debt crisis contagion to other euro area countries remains present. On the other hand, the European banking sector needs to increase high-quality capital and it faces the risk of refinancing the liabilities. The deterioration of

the private sector credit quality represents a constant source of risk. The level of deterioration, however, varies across different countries and institutions. The financial performance of these banking groups will be positively affected if the European authorities implement some anticipated measures to reduce the systemic risk in some euro area countries.

The Albanian economy expanded by 3.1% on average in 2011. After decelerating in 2011 Q2, it improved its activity in Q3 and Q4. The growth of economic activity continues to be steadily driven by trade and transportation sectors. The contribution of industry was volatile during 2011, while construction displayed slight improvement in its activity during 2011 H2. Indirect indicators suggest that the contribution of consumption and private investment to economic growth in 2011 was contained. The developments in government spending and foreign trade component also reflect the deceleration of their contribution. As at end-2011, unemployment rate stood at 13.29% compared to 13.49% at end-2010. This improvement was insufficient to support consumption further and shift households' propensity to save against a background of uncertainty about the future economic outlook. Annual inflation averaged 2.9% in 2011 H2, about 1.1 percentage points less than in 2011 H1. Against a background of contained inflationary pressures, the Bank of Albania cut the key interest rate in September and November by 0.25 percentage points each to 4.75%, hence providing more favourable monetary conditions to boost economic activity at home. At end-2011, budget deficit accounted for 3.5% of GDP. After the mid-year budget revision by the Government, revenues and expenditure reduced considerably in H2. The largest part of budget deficit was financed through domestic resources. Public debt accounts for 58.5% of GDP. After increasing in 2011 H1, the average maturity of debt deepened the downward trend, reaching in 2011 H2 the lowest level since 2008. As at end-2011, current account deficit accounted for 12% of GDP, increasing slightly from end-2010. Trade deficit reached 22% of GDP, narrowing by 1.5 percentage points from end-2010. At end-2011, exports covered 29.6% of imports compared to an annual average of 36%. Capital and financial account widened by 5.6% y-o-y, financing 80% of the current account deficit. In the real estate market, House Price Index for Tirana rose at a slower pace, while Rental Price Index maintained its declining trend. On the other hand, lending for housing purposes grew by 7.2% y-o-y.

Households/individuals and businesses' financial situation displayed the same trend in 2011 H2 as in the previous period. More specifically, individuals deepened their creditor position vis-à-vis the banking system further, following the considerable growth of deposits compared to the loans received. Creditor position in foreign currency expanded at a faster pace than that in the national currency. Businesses' debtor position continues to deepen and, for the most part, it is denominated in foreign currency. Lending to the business sector was considerably higher than that to households in 2011. In the meantime, loan quality deteriorated for businesses and households, with businesses suffering higher loan quality deterioration.

Financial markets in Albania were stable. In 2011 H2, the interbank market recorded higher traded values compared to the previous period. This change, however, was negligible y-o-y. Interbank rates reflected the key interest rate set by the monetary policy, the respective maturity structure of the transaction and the fluctuations in banks' demand for short-term liquidity. Over the period under review, the volume of Government bonds in the primary market declined compared to 2011 H1, reflecting the fall of Government demand for borrowing in 2011 H2. The composition of debt issued in the primary market was dominated by debt securities of up to 12-month maturity, although the decline in issues was present in T-bills and bonds. Average interest rate on debt securities issued in 2011 H2 remained close to the previous year's level. Compared to a year earlier, the average interest rate on T-bills decreased, while that on bonds increased. Debt securities trading market posted growth; however, the comparative base still remains very low. T-bills of 12-month maturity have the major share in the stock of securities traded in the secondary market. In the foreign exchange market, the Lek was stable, depreciating slightly against the Euro and appreciating against the US dollar. In addition, volatility in trading was low. Lek's exchange rate against the major currencies reflected the changes in supply/demand and the developments in the international foreign exchange market. Compared to 2011 H1, interest rate spread between loans and deposits denominated in Lek, Euro and US dollar narrowed, largely reflecting the lower interest rate on loans denominated in each of these currencies.

The financial system expanded its activity further in 2011 H2, in line with the key indicators established by the supervisory framework. Banking sector assets grew by 13.7% y-o-y to ALL 1,120.17 billion. Loans increased by 15.5% y-o-y, accounting for about 50% of total banking sector assets. Deposits grew by 13.2%, accounting for 81.4% of total banking sector's balance sheet. Foreign currency-denominated loans account for about 68% of the loan portfolio, while the share for deposits is almost equal. The average loan maturity is slightly lower, while increasing for deposits. Capital adequacy ratio improved to 15.6% at the end of the period due to the increase in capital for some banks. The continuous growth of deposits at a buoyant pace and the increase in liquid assets pursuant to the supervisory framework requirements provide evidence for a satisfactory liquidity situation. The positive profit, however, declined significantly at the end of the year, causing RoE and RoA to fall compared to end-2011 H1 and end-2010. The low return on investment in the international markets, the sluggish credit growth rates and the higher operating cost contributed to the fall in profit. The higher provisioning against credit risk, however, provided the major contribution in this regard. Loan quality deteriorated in almost all its categories. The ratio of non-performing loans to total loans stood at 18.8% at the end of the year. In 2011, the increase in non-performing loans ratio was slower than in 2010, but this primarily attributes to the faster growth of total loans.

The performance of the banking sector in 2011 H2 is also assessed through the Financial Strength Index (FSI), which increased by 3.2 units compared to the previous half of the year, but dropped slightly compared to the same period

in 2010. The higher FSI reflects the increase in liquidity and capital adequacy sub-indices and the exposure to exchange rate fluctuations. The sub-indices of asset quality, profitability and exposure to interest rate fluctuations provided an adverse contribution to the performance of the FSI.

In November 2011, the Assembly of the Republic of Albania approved some amendments to Law No. 9662, dated 18 December 2006 "On Banks in the Republic of Albania", drafted by the Bank of Albania. In addition to making some amendments in view of providing a clearer definition of electronic money activity and the respective financial institutions, in the framework of a better approach to the relevant EU Directive, the amendments aimed at determining the systemic risk and strengthening Bank of Albania's instruments for its addressing.

Risks to the financial system stem from its interaction with the surrounding economic environment and its own activity.

Concerning the impact of macroeconomic developments, it is assessed that fiscal stimulus and the contribution of foreign demand to economic growth will continue to fall. Fiscal policy should continue the consolidation process, aiming at keeping the budget deficit at low levels and gradually lowering the public debt level. In addition, demand for borrowing should make better consideration of the objective for extending the average duration of debt, in order to ensure more appropriate refinancing conditions, including a better reallocation across the institutional investors and individuals. Special attention must be also paid to the performance of foreign currency liabilities over time, which initially requires the creation and cautious management of foreign currency resources. These factors may sharpen the expectations of economic operators for the deceleration of economic growth and may increase the probability for the decline of private investment and consumption. The differences in the economic growth rates and real interest rates between Albania and our trading partners will impact the performance of trade and current account deficit. The direction and magnitude of this impact will, however, depend on other factors as well. It still remains vague. Trade deficit is high and it represents a potential risk to the macroeconomic developments in Albania. Its reduction may become stable only if supported by consistent and long-term policies that stimulate domestic production and improve its competitiveness. In the foreseeable future, the inflationary pressures may continue to remain weak, hence providing more opportunities for the monetary authority to maintain accommodative monetary conditions. The latter have been reflected in the performance of the average interest rate on deposits held with banks. The benefit level of economic operators in the market from the provision of more favourable monetary conditions would also depend on their financial situation and the amount of banking sector lending, as well as the respective interest rate.

Households and businesses are exposed to indirect credit risk; however, the magnitude of exposure varies due to their financial situation. Concerning households, exposure to adverse exchange rate movements mainly stem from

foreign currency loans for house purchase purposes. Exposure to adverse interest rate movements is assessed to have reduced in 2011 H2 due to the lower share of variable interest rate loans in total household loans. However, households' creditor position vis-à-vis the financial system smoothes out the effect of these risks. Concerning businesses, exposure to adverse exchange rate movements increased in 2011 H2 as a result of the higher share of foreign currency loans, unhedged against exchange rate risk, in total foreign currency loans. The quality deterioration for this category of loans was, however, lower than the decline in total value of business loans. Businesses also show higher exposure to adverse interest rate movements, when the latter increase. Businesses' capacity to cope with these risks is also affected by their debtor position vis-à-vis the financial system.

Concerning financial system's activity, direct and indirect credit risks represent the major risk, particularly to the banking sector. Loan quality deteriorated both for Lek and foreign currency loans, extended to businesses and households. However, its deterioration pace varied across the categories. Excluding the agriculture sector, the loan quality deteriorated in all the other sectors, and particularly in construction. In response to this situation, banks increased the level of their provisioning and strengthened the standard procedures for loan extension and monitoring. In this context, banks' actions to address non-performing loans, including the increase in the number of loan practices submitted to the court for collateral execution, have accelerated over the period under review. These actions are necessary and they should remain consistent in the future as well. Addressing non-performing loan concerns in the banking sector is important to the pace of loan extension and the future contribution of the banking sector and financial system to Albania's economic development. To this purpose, this issue was a topic of discussion in the last Financial Stability Advisory Group (FSAG) meeting. This meeting concluded that non-performing loans should be handled with priority, elaborately and thoroughly. Lowering the level of non-performing loans is a necessary step to release the considerable potential of the banking sector in financing valuable investment projects submitted by households and businesses. In this context, the FSAG made an assessment of the preliminary results of the work started by an ad hoc inter-institutional working group in identifying the legal and operational solutions that facilitate the collateral execution process, and encouraged their materialization. In addition, the FSAG pointed out that other regulatory and operational improvements, which facilitate and accelerate the loan-performing handling process need to be identified and implemented. The improvement of businesses' liquidity situation would have a positive impact on the improvement of banking sector's loan quality. The FSAG, therefore, suggested the government to provide its contribution by fulfilling its payment obligations to the private sector's contractors implementing different government projects in due time and in compliance with the legal provisions for maintaining the fiscal indicators.

The banking sector appears relatively hedged against direct risk arising from adverse exchange rate and interest rate movements. This is evidenced by the low open foreign exchange position and the comparable amount of interest

rate sensitive assets and liabilities in the banking sector's balance sheet. It, however, appears sensitive to the impact of exchange rate and interest rate movements on its clients. A significant level of exchange rate depreciation or a similar increase of the interest rate may impair banking sector clients' solvency, and particularly businesses' solvency. Special attention must be paid to foreign currency-denominated loans and their risks, particularly when the main source of its settlement is in the national currency. In the case of a long-term loan transaction, banks and their clients must make well-reasoned decisions regarding the performance of the interest rate in the future and the reciprocal mitigation of risk by establishing the most appropriate form of loan.

Liquidity risk to the banking sector is also at moderate levels. Deposits represent the key financial source for the banking sector and they grew at buoyant rates. Average maturity of deposits has increased. Borrowing from non-residents remains at contained levels. Banking sector's liquid assets in Lek and in the major currencies have increased as a result of higher regulatory requirements. Loan-to-deposit ratio remains at satisfactory levels and provides necessary room for developing the activity further. Banks can meet their short-term liquidity needs in the interbank market and they can participate in the liquidity injection operations conducted by the Bank of Albania on a regular basis. In this regard, banks, however, must be cautious in managing appropriate collaterals for borrowing in the interbank market.

Capitalisation indicators are generally at better levels than in 2011 H1. The considerable increase of capital by some banks, following the prudential requirements of the Bank of Albania, provided the major contribution to this improvement. However, banking sector's capacity to generate sufficient income to support the increase of capital, and develop its activity through domestic resources, needs to strengthen. Against a background of higher credit risk provisioning, banks should keep the performance of operating costs under control.

In order to assess the sensitivity of key banking sector capitalisation indicators to movements in macroeconomic indicators, the Bank of Albania conducts stress test exercises on a regular basis. Stress testing contains the baseline scenario and one or more risk scenarios. These scenarios include assumptions related to movements in the GDP growth rate, exchange rate and interest rate, and the level of credit, and they run over a two-year time period until end-2013. Stress test results show that, overall, the banking sector appears stable in the event the assumptions about the respective indicators take place. Capitalisation level for the entire sector remains above the minimum requirement in the event of the baseline scenario. In the event of the most severe scenario, which assumes the slowdown of lending and the fall in GDP growth rate, the banking sector may need additional capital. Individual banks need additional capital in the severe scenarios and the baseline scenario. In general, banking activity is carried out amidst a challenging internal and external economic environment. Banks should, therefore, monitor their activity closely, in order to identify and meet their needs for additional capital in due time.

The technical infrastructure supporting banking sector activity is assessed to have operated in line with the expected parameters. This infrastructure is mainly represented by the payments systems, which process all the transactions banks make between them, with their clients or the Bank of Albania, on their behalf or on behalf of their clients. Compared to 2010, the number and value of transactions in the Automated Clearing House System (AECH) increased in 2011. In the meantime, the number and value of transactions in the Real Time Gross Settlement System (AIPS) decreased. The latter owes to the increase in the threshold value of transactions cleared in the AECH system and the lower use of Bank of Albania's financial instruments by banks. The use of credit and debit cards has also increased. The pace of this increase was higher for credit cards due to the lower base. However, debit cards account for about 95% of cards in circulation. During the period under review, banks increased the number of ATMs and POSs further. As at end-2011, 11 banks offered internet banking services to their clients. The number and volume of transactions via the internet increased in 2011 H2.

I. DEVELOPMENTS IN GLOBAL MACROECONOMIC ENVIRONMENT

The recovery of global economy decelerated in 2011 H2, primarily due to the deepening of the sovereign debt crisis in the euro area, with significant impact on advanced economies. The uncertainty about the extent of European banks' exposure to sovereign debt and ability to cope with possible shocks was reflected in their tighter financing conditions by the markets. Economic growth in euro area countries is expected to be weak and this is likely to keep the contribution of foreign demand to the development of the country's economy at low levels.

1.1 OVERALL GLOBAL ECONOMIC DEVELOPMENTS

The annualised growth of global economic activity[3] reduced to 3.8% in 2011 compared to 5.2% in 2010. Advanced economies grew by 1.6%, while in 2012 they are expected to expand by 1.2%, mainly due to euro area's economic deceleration, fall of bank lending to real economy and the curbing effect of the fiscal consolidation process on economic growth. Emerging economies expanded by 6.2% in 2011. Growth in these countries is expected to decelerate to 5.4% in 2012.

After posting sluggish growth in 2011 H1, the U.S. economy recovered in H2, being largely driven by the increase in private investment, consumer spending and net exports. It expanded at an annualised rate of 1.7% in 2011, compared to 3% in 2010. Inflation rate, which peaked in September, pursued a decreasing tendency in the last months of 2011. Housing market remained weak, while the unemployment rate dropped in the last three months and in December 2011, it stood at 8.5%. Budget deficit (9.7% of GDP) and sovereign debt (84.9% of GDP) remain at high levels (see Table 1.1). The prolonged controversy over the reduction of the public debt level heightened the uncertainty related to the country's fiscal management concerns, which led to the downgrading of the sovereign credit rating on the U.S. by the S&P from "AAA" to "AA+" in August 2011. In light of the current macroeconomic conditions, the Federal Reserve decided to keep the target range for the federal funds rate at 0%-0.25%, and publicly stated its expectations for a similar rate until mid-2013.

Euro area's economic activity slowed down in 2011 H2, as a result of lower consumer spending and sluggish domestic demand in the large euro area's countries. Exports and imports increased moderately in 2011 Q3 and slowed down further in 2011 Q4. In December 2011, euro area's unemployment

[3] *IMF, World Economic Outlook, January 2012.*

rate rose to 10.4%. Against a background of weak economic growth, the inflationary pressures subsided in the last months of the year and are assessed as downward in the months ahead. Fiscal consolidation remains the main challenge for the euro area countries, therefore many of them, such as Italy, Spain and France have announced additional measures to further reduce the high accumulated debt.

Table 1.1 Selected macroeconomic indicators for USA and euro area

	GDP growth (y-o-y)			Inflation (annual rate)			Unemployment (in %)			Sovereign debt (% of GDP)		
	2011[1]	2011 Q2	2011 Q3	2011	Nov. 2011	Dec. 2011	2011	2011 Q3	2011 Q3	2010	2011 Q2	2011 Q3
USA	1.7	1.8	2.8	3.2	3.4	3.0	9.0	9.1	8.7	82.4	83.0	84.9:
Euro area	1.6	1.6	1.3	2.7	3.0	2.7	10.1	10.2	10.4	85.3	87.2	86.8
Germany	2.7	2.9	2.6	2.5	2.8	2.4	5.9	5.8	5.5	83.2	82.0	81.8
France	1.7	1.7	1.5	2.3	2.7	2.7	9.7	9.7	9.9	82.3	86.0	85.2
Italy	0.6	0.7	0.2	2.9	3.7	3.7	8.4	8.6	8.9	118.1	121.2	119.6
Greece	-5.0	-7.4	-5.0	3.1	2.8	2.2	-	18.8	19.2[2]	144.9	154.7	159.1

Source: Bureau of Economic Analysis, Eurostat database, ECB - Monthly Bulletin, IMF's database

1 *IMF's estimates of euro area's GDP growth in 2011 (September 2012). BEA's (Bureau of Economic Analysis) estimates for the U.S.*

2 *October 2011.*

Economic activity in Central and Eastern European countries recovered in 2011 H2. The recovery rates were not, however, uniform across the countries. In Bulgaria, the Czech Republic and Slovakia, the growth rate slowed down in Q3 compared to the previous periods, mainly due to the fall of external demand and poorer investment. On the other hand, Poland and Romania continued to record satisfactory growth, driven mainly by domestic demand. In the Balkans, Turkey and FYROM recorded higher growth rates. Annual inflation pursued a declining trend or remained unchanged in most of the countries in the region, excluding Turkey. Euro area's debt crisis effects are expected to affect the Central and Eastern European countries considerably due to the strong commercial and financial ties between these countries and the euro area. The IMF estimates that GDP in this region grew by 4.25% in 2011 and it expects it to slow down to 2.75% in 2012.

Table 1.2 Selected macroeconomic indicators for Central and South-Eastern Europe

	Real GDP growth (in %)			Monthly inflation (annual %)			Monthly unemployment* (in %)			
Central and South-Eastern Europe	2011[1]	Q2[2]	Q3	2011[3]	Nov-11	Dec.-11	2011[4]	Q2	Q3	Q4
Hungary	1.8	1.7	1.5	3.9	4.3	4.1	10.9	11.0	10.8	10.9
Bulgaria	2.5	2.0	1.6	3.4	2.6	2.0	11.1	11.2	10.9	11.2
Romania	1.5	1.9	4.4	5.8	3.5	3.2	7.3	7.3	7.7	7.0
Serbia	2.0	2.5	0.5	11.26	8.1	7.0	20.5	22.2	-	23.7
FYROM	3.0	5.0	2.3:	4.4	3.5	2.8	32.2	31.3	31.3	:
Kosovo	5.3	5.5	:	8.3		3.6	-	-	-	-
Turkey	6.6	8.8	8.3	6.0	9.5	10.4	10.5	8.3	8.3	:

Source: Eurostat database, IMF's database, respective central banks, respective statistical institutes

1 *IMF's estimates of GDP in 2011.*

2 *Quarterly (annualised) GDP data have been obtained from Eurostat, and respective central banks and statistical institutes.*

3 *IMF's estimates of inflation in 2011 for the countries in the region.*

4 *Eurostat's data on unemployment in Hungary, Bulgaria and Romania. IMF's data of unemployment in 2011 for the countries in the region. Quarterly data on unemployment have been obtained from the respective central banks.*

Some of the economic developments in the euro area and the region may impact on the Albanian economy as well. More specifically, the fall of aggregate demand in these countries will provide an adverse contribution to the Albanian exports' terms of trade. In addition, the deterioration of the labour market conditions in the euro area, and in particular in Italy and Greece[4], combined with the additional fiscal tightening measures in these countries, may impact on Albanian emmigrants' financial situation negatively, thereby lowering their capacity to accumulate savings and remit them to their country of origin further. The possible decrease in exports and remittances lower foreign currency resources and, unless compensated by a similar fall of demand for foreign currency, they may exert increasing pressure on the depreciation of the Albanian Lek. On the other hand, the receding inflationary pressures on a global level and in Europe may bring foreign prices down. The performance of oil prices in the international markets remains, therefore, a risk factor.

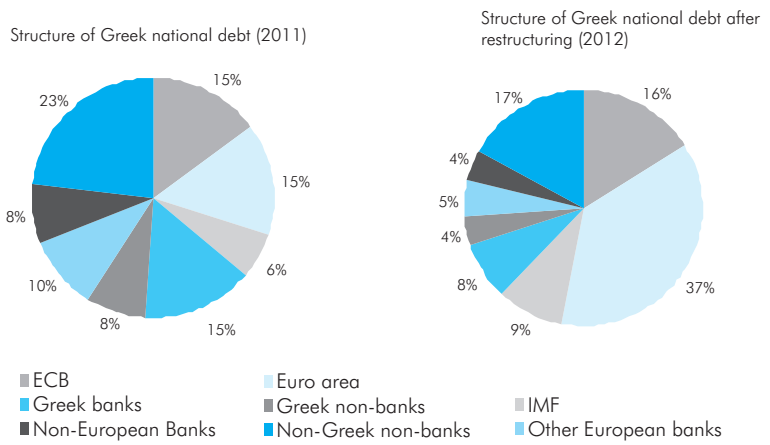
[4] *See Box 1.*

BOX 1 SETTLEMENT FOR THE RESOLUTION OF GREEK SOVEREIGN DEBT

On 21 February 2012, euro area finance ministers endorsed a second bailout package for Greece worth EUR 130 billion to meet the immediate national debt settlement needs. This settlement aims to reduce the national debt to 120.5% of GDP by 2020. It will enable Greece to launch a bond swap with private investors to help lower and restructure debt and stabilise Greece's financial situation.

About EUR 100 billion of debt will be written off as banks and insurers swap bonds they hold for longer-dated securities that pay a lower coupon. Private sector holders of Greek debt will take losses of 53.5% or more on the nominal value of their bonds. This settlement will help Greece repay EUR 14.5 billion of debt to private investors due on 20 March 2012.

Chart 1.1 Structure of Greek national debt before and after restructuring



Source: Bank of Greece

The vast majority of the EUR 130 billion fund will be used to finance the bond swap and ensure Greece's banking system remains stable: about EUR 30 billion will go to the private sector to facilitate the signing up of the swap, a further EUR 35 billion

will allow Greece to finance the buying back of the bonds, EUR 5.7 billion will go to paying off the interest accrued on the bonds being traded in. About EUR 23 billion will go to recapitalize Greek banks.

In this process, the Bank of Greece will make an assessment of banks' capital needs and their recapitalisation plans within 2012 Q1. Further on, the Bank of Greece is expected to communicate to banks specific deadlines to raise capital in the market by September 2012. Banks submitting viable capital raising plans will be given the opportunity to apply for and access capital from the Hellenic Financial Stability Fund, which has about EUR 40 billion at its disposal for this purpose.

Worth noting is that debt restructuring has brought about lower Greek banks' exposure to national debt, down from 15% to 8% of unsettled debt. In this way, there is higher exposure (debt transfer) in the euro area countries, as shown by Chart 1.1.

1.2 FINANCIAL MARKETS HIGHLIGHTS

The higher sovereign debt risk in the euro area and the concerns related to the deceleration of global growth had a subsiding effect on the financial markets in 2011 H2. The tensions mainly affected the European markets and less the U.S. or emerging countries.

Money markets in the euro area were highly volatile and interest rates were upward. In order to relieve pressures, the European Central Bank employed different financial instruments to increase the liquidity in the market and cut the key policy rate twice by 25 basis points each in November and December, respectively, to 1%. Despite the high liquidity level, the trading volumes in the interbank market remained generally low in 2011 Q4 and the risk premium grew higher than in the other markets, also reflecting the higher perceived credit risk for interbank operations.

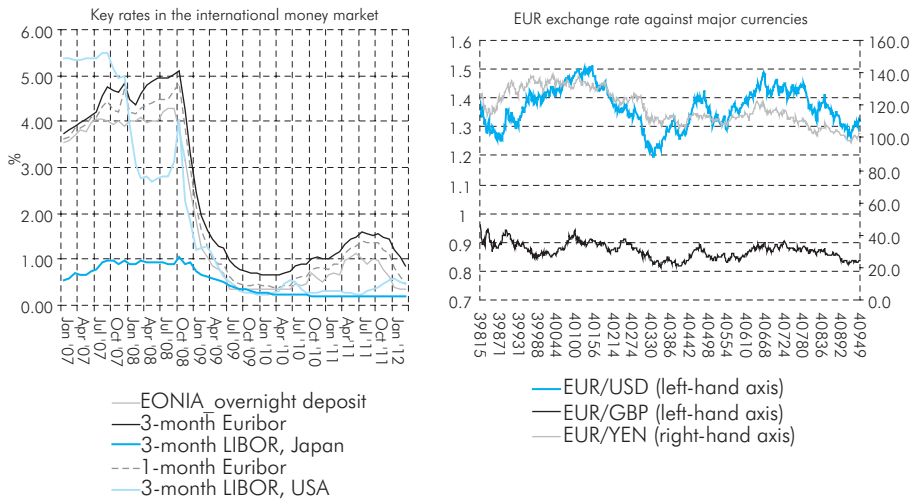
Developments in euro area's government bond markets were characterised by heightened uncertainty and pronounced heterogeneity across the countries. Pressures over the increase of the yields on government bonds grew particularly for high-debt countries such as Italy and France. The lack of confidence for a rapid solution to the euro area debt crisis reinforced due to the sluggish economic performance and encouraged the movement of capital to safer markets. As a result, the yields on German and U.S. government bonds dropped swiftly and their spreads to some euro area countries' widened. In order to smooth out the volatility of prices and the spread of uncertainties to other market segments, the governments of the countries most exposed to high public debt levels continued to apply a wide range of tight fiscal measures[5].

[5] *See Box 2.*

Activity in the equity markets decreased considerably in 2011 Q2 and Q3, due to investors' reluctance to invest in corporate shares and bonds. This, in turn, maintained the pressure over the increase of the yields on private debt securities, and caused vulnerability to the major global stock markets. In the foreign exchange markets, investors turned to safer currencies, such as the Japanese yen and the Swiss franc. Against this setting, throughout 2011 H2, the Euro has generally been unstable against the major currencies.

In primary commodity markets, prices showed a declining tendency due to the sluggish global demand. Oil price, however, rose at end-2011, mainly owing to supply-side developments and heightened geopolitical risk in oil-producing countries. Concerning the other types of primary commodities, the improvement of production conditions and weakening of global demand are expected to lead to the fall of their prices. According to the IMF, non-oil commodity prices are expected to fall by 14% in 2012.

Chart 1.2 Interest rates and the performance of euro in global markets



Source: European Central Bank (left), Source: European Central Bank, Eurostat (right)

BOX 2 KEY MEASURES OF ITALIAN AND SPANISH GOVERNMENTS TO ACHIEVE FISCAL CONSOLIDATION AND RECOVER ECONOMIC GROWTH

ITALY: The deepening of the sovereign debt crisis in the euro area was reflected in a set of urgent fiscal consolidation measures in Italy, whose public debt is the second largest in the EU and, for many years, the last in terms of the economic growth rate. These measures aimed at enhancing fiscal consolidation against a background of lack of confidence in financial markets, which exerted pressure over the interest rates on Italian debt. During 2011, the Italian Government introduced the following three main fiscal packages:

- *Law Decree No. 98, dated 6 July 2011, introduced urgent measures for fiscal stabilization, such as cuts in transfers to local authorities and health spending. With the amendments brought in by the conversion law of July 2011, the fiscal package of the year, which had originally been set at EUR 40 billion, was increased to EUR 48 billion. This increase was almost entirely due to higher government revenue, owing to the increase in excise duties on petrol, and higher medical fees and pension solidarity contributions.*

- *Despite these measures, financial market speculations against Italy did not curb. As a result, in August 2011, the Italian Government introduced further fiscal consolidation measures. These included provisions for a primary balance of 0% in 2011 to reach a surplus of 6% by 2014, with half of the adjustment planned for 2012. This adjustment was based on tax increases rather than spending cuts.*

- *On 6 December 2011, the new Italian Government passed Decree No. 201, converted into Law on 22 December. The third economic package of 2011 aimed at enhancing financial markets confidence in the Italian economy in order to avert a sovereign debt crisis. Among the most significant measures was the re-introduction of the prima casa tax (on primary residence), which is considered to have a considerable impact in Italy, where families tend to invest in purchasing their main home. Particularly significant was the acceleration of the pension reform, which meant that, from 1 January 2012, all workers were brought into the contributions-based system, thus including even workers who had previously been exempt from this obligation. The package also abolished the seniority pension as traditionally provided for under the pension system, replacing it with the early-retirement pension, which can be drawn, as of 2012, and regardless of age, by people with 42 years and one month of contributions for men and 41 years and one month for women. The package also provided for raising the pension contribution rate for autonomous workers and workers with temporary contracts. It also raised the pension age for all employees and the self-employed, and for public sector employees to 66, as from 1 January 2012. For women in the private sector, both employees and the self-employed, the new pension age is being phased in, rising to 62 years in 2012 and culminating at 66 years as from 2018. In addition, the package abolished the indexation of pensions, excluding those at the lower end of the scale. Lastly, the December package also retained the safeguard clause included in previous packages: should the tax and welfare measures not come into force to allow savings of at least EUR 4 billion to be achieved in 2012, a further hike in the VAT rate will be introduced from October 2012.*

SPAIN: Public deficit reduction measures have been introduced since 2010, with particular emphasis on cutting spending within the different public authorities. Spain suffers from the contraction of the economy, very high unemployment and frail banking sector situation.

Royal Decree-Law No. 8/2010 introduced a series of actions aimed at controlling the public deficit resulting from the economic and financial crisis. The main regulatory measures were:

- *Suspension of the adjustment of pensions for 2011, except for minimum pensions and non-contributory pensions.*
- *Reduction in the salaries of public employees by an average of 5%, from June 2010 to December 2011.*
- *Change to the time limit for granting health care benefit to six months from submission of its request.*
- *Removal of lower taxation for birth or adoption on personal income.*
- *Removal of the single payment birth and adoption grant from social security.*
- *A delay in the economic and financial actions of local authorities.*

Royal Decree-Law No. 8/2011 required the spending of public administration and local authorities to be in line with the medium-term growth of the Spanish economy, defined as GDP growth, expressed in nominal terms. Furthermore, this regulation dealt with taxation, as a means to promote business activity, by modifying personal income tax, company taxes, tax on the income of non-residents and property tax.

Even after this, the Spanish Government was again urged by the European authorities to continue the policy of reforms under way. Thus, in September 2011, the government was able to reform Article 135 of the Constitution to promote budgetary balance, thereby establishing that all public authorities would bring their actions into line with the principle of budgetary stability, making the payment of public debt interest and capital an absolute priority.

Later measures adopted to limit and contain the public deficit refer to the Royal Decree-Law No. 20/2011 of December 2011, on urgent fiscal and financial measures. This decree introduced significant changes to the tax policy and it aimed at decreasing the forecast deficit to 6% for 2011 and to 4.4% for 2012.

Reforms also extended to the social insurance system to reduce the costs of retirement pensions. The most significant changes to the contributory retirement pension were:

- *Raising of the pensionable age from 65 to 67 years, unless by 65 years the person has contributed for 38.5 years.*
- *Increase in the years of contribution for the calculation of the base for the retirement pension, from 15 to 25 years, which will mean lower pensions, since workers' salaries are generally lower during the early years of their working lives than in the later years.*

Banking system developments – Operating environment conditions for Global Large and Complex Banking Groups (GLCBG) became more challenging in 2011 H2[6]. After a good performance in the beginning of the year, profitability indicators (RoE) and net income shifted downward in Q2 and stabilised in Q3. The low interest rates and weak credit growth were reflected in a significant decline of interest income of some banks. Trading income also decreased due to the higher tensions in the financial markets. Average Tier 1 capital ratio of GLCBG in 2011 Q2 and Q3 stabilised at 13.4% and 13.3%, respectively. The deteriorating outlook for global economy may oblige these banks to increase loan loss provisions.

The financial performance of euro area Large and Complex Banking Groups deteriorated in 2011 H2, mainly due to higher loan loss provisions and a pronounced deterioration in trading income, against a background of heightened uncertainty in the European financial markets and deteriorating economic situation in some euro area countries. On the other hand, the fiscal tensions in the euro area impaired European banks' capacity to refund their liabilities, particularly in countries with high exposure to Greece and its financial institutions. EU-wide stress testing exercise conducted by the European Banking Authority (EBA) showed that the major euro area banking groups need to raise their capital following their exposure to EU countries' sovereign debt[7]. In light of this situation, many European banks have made efforts to lower their direct exposure to countries facing fiscal constraints, including the quick recording in the balance sheet of losses arising from these exposures. Looking ahead, the uncertainty surrounding the future outlook of euro area government securities markets will remain high, and the risk that the crisis could spread to other euro area countries with high public debt levels remains present. On the other hand, the European banking system continues to face the funding risk due to lower funds and higher funding costs for banks. In addition, the deterioration of the private sector (households and non-financial corporations) credit quality represents a constant source of risk. The level of deterioration, however, varies across different countries and institutions.

[6] *ECB - Financial Stability Review, December 2011.*
[7] *See Box 3.*

BOX 3 STRESS TEST RESULT ON THE MAJOR EUROPEAN BANKING GROUPS ACCORDING TO THE EUROPEAN BANKING AUTHORITY

The European Banking Authority (EBA) (www.eba.europa.eu) published, on 8 December 2011, recommendations and stress test results on 90 European banking groups, following the revaluation of exposures to EU countries' sovereign debt, as at 30 September 2011. Banks are required to reach a 9% ratio of core Tier 1 capital to risk-weighted assets by 30 June 2012. To achieve this, in total, the European banks in the EBA sample must raise the capital by about EUR 114.7 billion.

The following table provides the needs of banks with capital shortfall in some European countries.

Table 1.3 Capital raising needs of banking groups by country

Country	Capital raise (in EUR billion)
Spain	26.2
Germany	13.1
Italy	15.4
Greece	30.0
France	7.30

Source: EBA Stress Test

Despite the stress test results, the concrete capital requirements for the Greek banks will be defined in the Troika agreement (European Union, European Central Bank and International Monetary Fund).

Concerning the European banking groups operating in Albania, the EBA recommends a EUR 2.1 billion capital raise for Raiffeisen Bank and Societe Generale, while Intesa San Paolo and Credit Agricole are not required to raise their capital.

Table 1.4 Capital-raising needs of banking groups operating in Albania

Bank	Capital raise (in EUR billion)
Raiffeisen	2.13
Intesa San Paolo	0
Societe Generale	2.1
Credit Agricole	0

Source: EBA Stress Test

The EBA underlines that the required capital raise is an extraordinary and temporary measure. It also acknowledges that it will review its decision at a later moment (without making any specifications of the date) if the sovereign debt conditions improve.

According to EBA's recommendations:

1) *If the National Supervisory Authorities (NSAs) agree with the recommendations and banks' results (required to be submitted to the EBA by 8 February 2012), all banks must submit, by 20 January 2012, to the NSAs their capital-raising plans;*

2) *Prior to agreeing these capital plans, NSAs will consult with relevant colleges of supervisors (according to importance and suitability) and with EBA;*

3) *Capital raise should aim at not disrupting lending to the real sector of EU's economy.*

4) *Banks should first use private sources of funding to strengthen their capital position, including retained earnings, reduced bonus payments, new issuances of common equity and suitably strong contingent capital, and other liability management measures. In addition, reductions in risk-weighted assets should not, in general, be allowed as a means of addressing a capital shortfall, unless these changes are already planned and under consideration by the NSA.*

DEVELOPMENTS IN BANKING GROUPS OPERATING IN ALBANIA

The table below summarises financial statement data of the banking groups operating in Albania. Compared to the previous year, income statement figures show a downward tendency of earnings, mainly due to the lower income of these banking groups, despite the fall in spending. Capital adequacy ratio is at satisfactory levels, thereby requiring no additional capital based on the effective regulatory criteria. The ratio of total assets of each individual bank in Albania to total assets of the group remained at a similar level for all banking groups under review.

Table 1.5 Financial data on foreign banking groups operating in Albania

	Raiffesen Bank International[i]	Intesa San Paolo[ii]	Alpha Bank*[iii]	Piraeus Bank*[iv]	National Bank of Greece*[v]	Societe Generale[vi]	Credit Agricole[vii]
Total assets	146.9	639.2	62.7	55.5	115.5	1,181.4	1,879.5
Annual change	12.1%	-2.7%	-7.4%	0.0%	-6.0%	4.0%	
Volume of loans to customers	81.5	376.7	47.2	35.5	73.2	367.5	799
Annual change	7.8%	-0.5%	-5.4%	-4.0%	-2.0%	-1.0%	
Volume of customer deposits	66.7	357.4	31.7	24.5	60.7	340.2	666.7
Annual change	15.8%	-10.5%	20.5%	15.0%	-13.0%	1.0%	
Non-performing loans ratio	8.6%		11.6%	11.7%			
Provisioning	1	2	2.7	0.9	1.3		
Net profit	0.9	-8.1	0.1		-1.3	2.4	1.1
Annual change	-11.0%		-62.9%	12.0%		-39.1%	-72.4%
Operating income	5.4	16.7	1.7		3.1	4.27	13.5
Annual change	1.3%	1.5%	2.4%		-6.0%	-25.3%	1.1%
Net interest income Annual change	2.5%	0.8%	-3.1%	4%	-8%		
Net commission income Annual change	-0.1%	-3.3%	-15.2%	1.0%	-18.0%		
Operating expenses Annual change		-1.8%	-2.6%	4.4%	-5.0%	3.0%	3.7%
Personnel cost Annual change	6.0%	-2%	-2.7%	-4.0%	-6.0%		
General spending Annual change	4.7%		-3.1%	-7.0%			
Net operating profit Annual change	-2.8%	5.9%	-45.1%				
Net interest margin	2.61%		2.8%		3.66%		
Capital adequacy ratio	9.9%	11.5%	12.3%	8.8%	10.7%	10.7%	10.2%
Total bank assets in Albania to total group assets	1.57%	0.14%	0.84%	1.16%	0.25%	0.03%	0.01%

**The data are in billions of EUR and refer to the first nine months of 2011.*

Source: Banking groups' financial results

[i] *Annual Report 2011, URL: http://investor.rbinternational.com/fileadmin/ir/2011_FY/2012-03-29_2011_Annual_Report_RBI.pdf*

[ii] *Consolidated financial results 2011, URL: http://www.group.intesasanpaolo.com/scriptlsir0/si09/eng_index.jsp#/investor_relations/eng_comunicati_stampa_price.jsp*

[iii] *Nine-month 2011 results, Press Release, URL: http://www.alpha.gr/files/deltia_typou/Deltio_Typou_20111128EN.pdf;*

[iv] *9M 2011 Results, URL: http://www.piraeusbank.gr/Documents/internet/PressReleases/2011/9m_Results_en.pdf*

[v] *9M 2011 results, URL: http://www.nbg.gr/wps/wcm/connect/7425d800493daac4b386f736172d79c7/Press_Release_EN_9M_2011.pdf?MOD=AJPERES&CACHEID=7425d800493daac4b386f736172d79c7*

[vi] *Financial Information, 2011, Press Release, URL: http://www.societegenerale.com/sites/default/files/B33AF0101F8ABE99C12579A60020D74F.pdf*

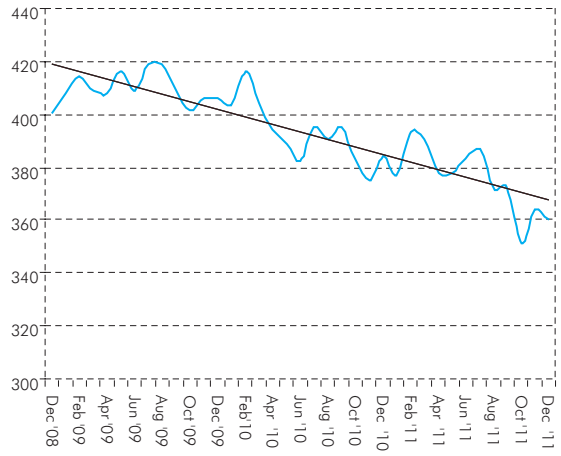
[vii] *Financial Statements for 2011, URL: http://www.credit-agricole.com/en/Finance-and-Shareholders/Financial-reporting/Credit-Agricole-S.A.-financial-results*

II. DEVELOPMENTS IN ALBANIAN MACROECONOMIC ENVIRONMENT

2.1 REAL SECTOR ECONOMY

The Albanian economy expanded by an average of 3.1% in 2011. After decelerating in 2011 Q2, its activity improved in Q3 and Q4. The sectors of trade and transportation continue to drive the growth of economic activity at a steady pace. The contribution of industry was volatile during 2011, while construction improved its activity in 2011 H2. Indirect indicators suggest that the contribution of consumption and private investment to economic growth in 2011 was contained. Developments in Government spending and foreign trade component also reflect the deceleration of their contribution.

Chart 2.1 Average duration of days left to maturity for debt issued in securities



Source: Ministry of Finance

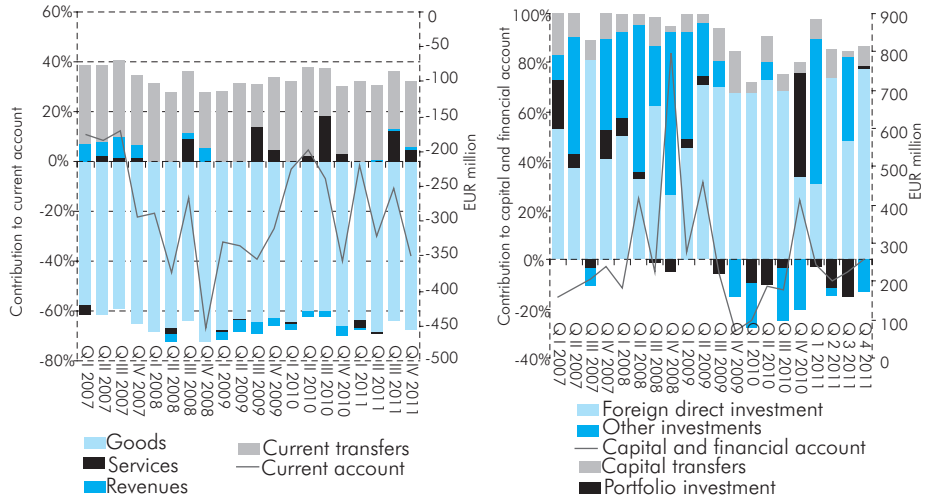
More specifically, as at end-2011, general government revenue increased by 1.8% y-o-y, while expenditure increased by 3.7%. Consequently, fiscal deficit deepened by 20.2% y-o-y to ALL 45.7 billion, thereby accounting for 3.5% of annual GDP. 57% of deficit financing was made through domestic resources. Public debt stock amounted to ALL 772.5 billion, increasing by 8% versus end-2010 and climbing to 58.5% of GDP. Debt issued in the domestic market accounts for about 57% of the stock. External debt accounts for the rest, 43%. The structure of external debt at concessional terms maintained the recent years' upward trend of the debt stock on commercial terms, which shares about 49.5% of the stock, compared to 48.3% at end-2010. The average maturity of debt issued in securities deepened the downward trend during 2011, averaging 360 days left to maturity in December 2011.

At the end of 2011, current account deficit was estimated at EUR 1,145 million or 11.98% of GDP, up by only 0.08 percentage points from end-2010 (11.9%). For the same stated period, trade balance deficit was estimated at EUR 2,106.96 million or 22% of GDP, down by 1.5 percentage points from end-2010. This performance reflects largely the faster increase of imports by 10.2% y-o-y, while exports increased by 7.9% y-o-y. At the end of 2011, exports covered 29.6% of imports, compared to an annual average of 36%.

On the other hand, capital and financial account widened by 5.6% y-o-y, amounting to EUR 921.2 million and financing 80% of the current account

deficit. The increase in other investments provided the major contribution to the widening of the capital and financial account, while foreign direct investments and capital transfers narrowed by 9.7% and 0.8% y-o-y, respectively.

Chart 2.2 Current account and capital and financial account by respective components



Source: Bank of Albania

Although consumer confidence improved at the end of 2011[8], the contribution of consumption to economic growth was contained. Workers' remittances declined by 0.23% y-o-y in 2011, while in H2 they recorded an annual increase of 14% versus an annual decline of 11.3% in H1. Operational data indicate that this increase in remittances in the second half of the year has also reflected the entry of funds associating the repatriation of a part of emmigrants due to the severe economic situation facing the neighbouring countries. The entry of funds as a result of emmigrants' repatriation represents a relatively larger and simultaneous capital inflow but it reduces the potential resource size of remittances and the consistency of their value over time. They, however, may in the short run contribute to the improvement of consumption and private investment in Albania. Consumption was driven by the relatively positive developments in the labour market. At the end of 2011, unemployment rate stood at 13.29% compared to 13.25% at end-Q3 and 13.49% at end-2010. In 2011 Q4, the number of employed people in the private non-agricultural sector increased by 6.7% y-o-y, while the number of employed people in the public sector and private agricultural sector remained unchanged from 2011 Q3 and decreased by 0.6% y-o-y. Expectations[9] for the labour market in the beginning of 2012, albeit lower, are assessed as positive.

Annual inflation averaged 2.9% in 2011 H2, about 1.1 percentage points less than in H1. Against a background of contained inflationary pressures and,

[8] *Consumer Confidence Index improved by about 3.1 percentage points at end-2011 compared to the previous year, mainly due to the improved balance of large purchases.*

[9] *According to Business Confidence Index, in 2011 Q4, construction and services sectors report lower expectations for employment, while industry expects slower increase of employment.*

in order to provide monetary stimulus and boost economic activity at home, the Bank of Albania cut the key interest rate in September and November by 0.25 percentage points each to 4.75%.

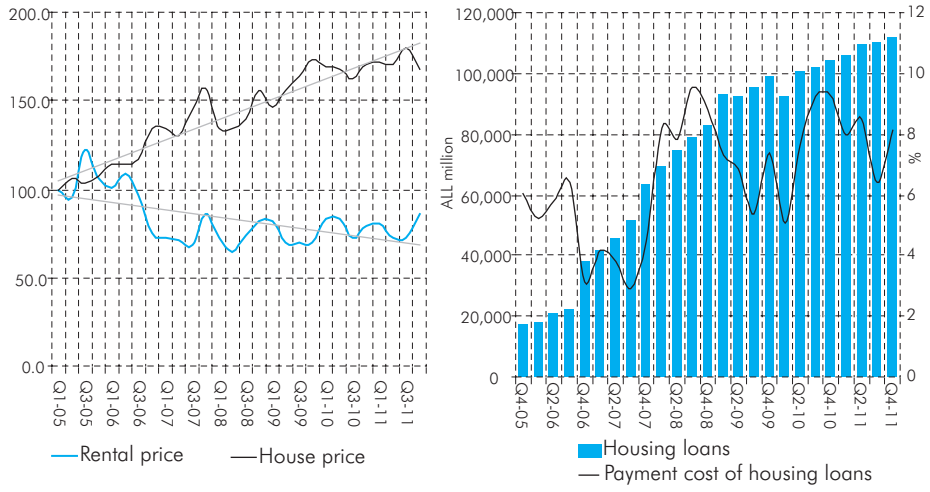
2.2 RESIDENTIAL HOUSING MARKET

House Price Index slowed down its increase in 2011 H2, while Rental Price Index maintained its decreasing trend. Loans for housing purposes showed signs of recovery.

2.2.1 RESIDENTIAL HOUSING MARKET DEVELOPMENTS

House Price Index[10] decreased by 1% y-o-y in 2011 Q4, while recording an average increase by 2.9% for the entire year. The average growth rate was higher in the previous year, by 5% y-o-y. Rental Price Index recorded an average decrease by 2% in 2011, compared to an increase by 10% in 2010. As a result of these developments, price-to-rent ratio increased to an average of 2.12 in 2011, compared to 2.01 in 2010.

Chart 2.3 House and Rental Price Indices and housing loans



Source: Bank of Albania

Despite the deceleration in the house price increase, lending for house purchase purposes recovered in 2011. In December 2011, it expanded at an annualised rate of 7.2%, up by 1.4 percentage points from the same period in 2010. The relative cost of loan payment for house purchase also increased at the end of 2011, mainly due to the higher interest rate on housing loans[11].

[10] *House and Rental Price Indices are constructed only for Tirana.*

[11] *The relative cost of loan payment for house purchase is measured as the difference between the interest rate on housing loans and the average growth rate of house prices in the last four quarters. If the interest rate increases faster than the raise in house prices, then the relative cost is higher and vice-versa.*

These developments suggest that despite the lower household demand for housing loans in 2011 H2[12], the easing of bank lending standards applied to households has dampened this effect. However, banks' expectations regarding household demand for housing loans in 2012 Q1 remain pessimistic, although banks report easier lending standards applied to total household credit compared to end-2011.

Another important aspect of housing loan is its quality, which deteriorated in 2011. In December 2011, the ratio of non-performing housing loans stood at 12.55% versus 9.01% in the previous year. Housing loan portfolio is more qualitative compared to total loan portfolio, where non-performing loans account for 18.76% of outstanding loans. This performance reflects stronger financial discipline related to housing loans due to the significance of the collateral to the borrower. Although housing loan portfolio quality risk appears at moderate levels, its constant monitoring is necessary considering the 20% share this type of loan has in total bank loans.

[12] *According to the Bank Lending Survey for 2011 Q4, household demand for house purchase fell to negative rates of 4.1 and 15.2, respectively, in 2011 Q3 and Q4. In the meantime, banks report that the lending standards applied to household loans remained unchanged from the previous quarter, thereby evidencing an improved situation compared to the tightening of the lending standards over the course of 2011.*

BOX 4 INTERACTION BETWEEN HOUSE PRICES AND LOANS FOR HOUSE PURCHASE

The rise in house prices, as measured by the House Price Index, has been significant since 2005. This performance has increased considerably the borrowing capacity of economic agents through the collateral effect, while the rapid growth of loans for house purchase has reflected in a higher share of this component in total economic agents' liabilities. In the event of higher agents' credit risk due to developments in interest rates or the level of income, the potential negative impact may deteriorate further if coupled with a fall in house prices.

The purpose of this box is to evaluate the interaction between the performance of house prices and loans for house purchase, in order to assess this risk to the country's financial stability. The evaluation of this interaction is based on the paper by Gimeno and Martinez-Carrascal (2006) "The Interaction between House Prices and Loans for House Purchase – The Spanish Case". The model is in the form of Ordinary Least Squares Method and it includes quarterly data covering the period

DLOG(ICB)= 0.022-0.32*DLOG(HPI(-2))-0.025*D(COST_TB) + 0.22*DLOG(CREDIT(-4))
Probability (0.05) (0.04) (0.00) (0.00)

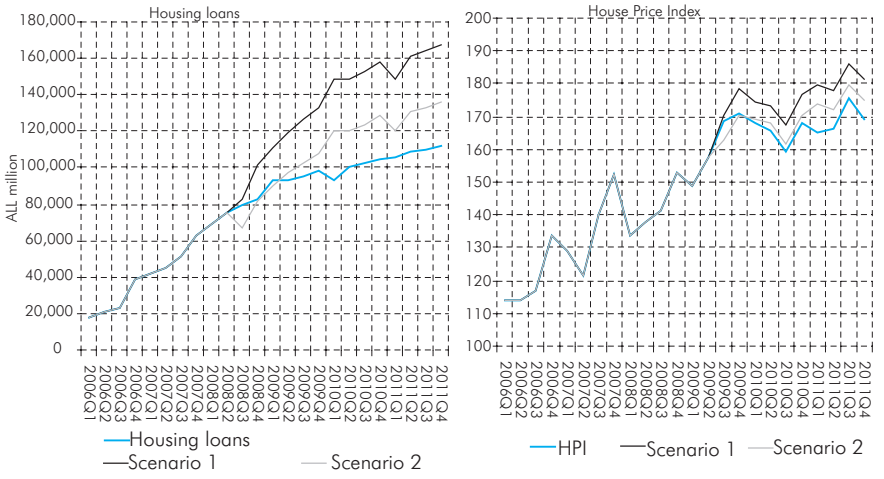
+ 0.05*DLOG(INF)-0.073*SEAS(1) + 0.021*D(INTEREST(-2))
Probability (0.07) (0.00) (0.04) R^2 Adjusted =0.79

2005-11 as shown below:
Where: HPI-House Price Index; COST_TB-cost of alternative investment in T-bills as measured by the difference between 12-month T-bill rate and HPI growth rate; CREDIT-outstanding loans for house purchase; INF-annual inflation rate; SEAS-seasonal factor for the first quarter of the year and INTEREST-interest rate on loans for house purchase.

The results suggest that the growth of loans for house purchase provides the highest impact on the rise in house price, with a time lag of one year. In the meantime, the increase in the interest rate on loans for house purchase affects negatively, but at a low coefficient, on the rise in house price. Lastly, the higher cost in an alternative investment of funds through T-bill purchase has a negative, albeit low, impact on the house price performance. This implies that a very high yield on an alternative investment (which, for the moment, is represented only by T-bills due to investment limitations in Albania) would be required for households' behaviour to be reflected in the fall of domestic house prices.

In order to evaluate the direct impact of loans for house purchase on house prices, in the wake of post-global financial crisis, we make a sensitivity analysis. This analysis is based on the above equation and assumes two possible scenarios. The first scenario presents the possible performance of the House Price Index if the growth of loans for house purchase for the period 2008 Q3-2011 were similar to the pre-crisis period (end-2007). In the second scenario, the performance of the annual growth of loans for house purchase for the same stated period is assumed to be as much as half of the pre-crisis' growth rate, which, however, remains higher than the current performance of this type of loan.

Chart 2.4 Performance of loans for house purchase and house price based on the two scenarios



Source: Financial Stability Department's estimates

Exercise results suggest that if loans for house purchase continued to grow at similar rates to the pre-crisis period, house prices would rise at a faster rate than their actual performance. The results for the evaluation of the positive correlation between the performance of loans and house prices are as expected.

Worth noting, however, is that there are a number of other elements affecting the performance of these indicators. Despite the rapid growth rates of loans for house purchase, it should be noted that it started from a very low base level. At the end of 2011, loans for house purchase accounted for less than 10% of Albania's GDP, while the average level of loan per capita or per borrower continues to remain lower than in similar countries. On the other hand, the continuous rise in house prices also reflects the rapid growth of demand against a background of expanding economic activity, a form of investment of remittances, improved housing quality, etc. This exercise, however, underlines the importance of the interaction between the housing market and financing in the form of loan, whose monitoring is necessary in view of safeguarding financial stability in the country.

2.3 HOUSEHOLDS' FINANCIAL SITUATION AND BORROWING

2.3.1 SURVEY OF HOUSEHOLDS' FINANCIAL SITUATION AND BORROWING

- *FINANCIAL SITUATION*

In November-December 2011, the Bank of Albania, in cooperation with INSTAT, carried out the third survey of households' financial situation and borrowing in Albania, having as the reference period the second half of 2011. The survey is based on a sample of 1,210 households, distributed relatively in 27 different districts, with about 55% living in the urban areas and 45% in the rural ones. According to the survey results, the main sources of income in 2011 H2 were: employment in the private sector, retirement pension and self-

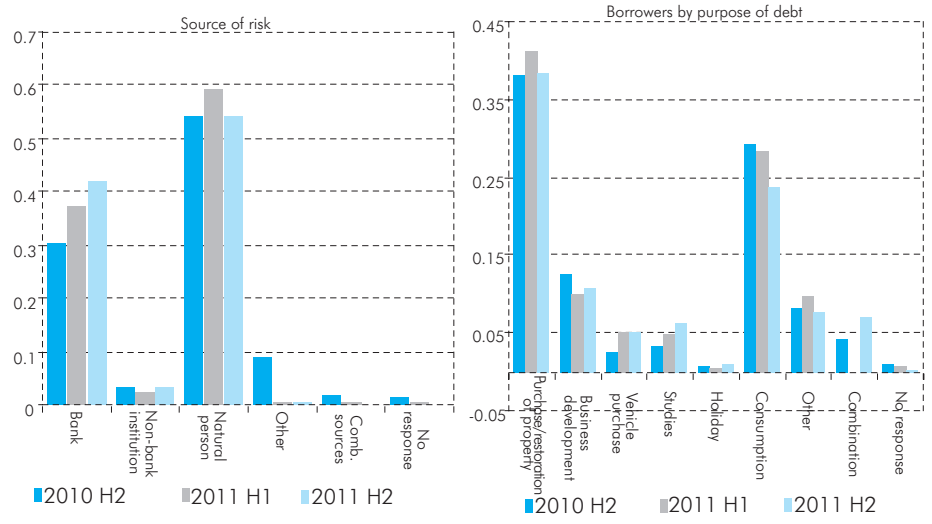
employment, for respectively 27%, 30% and 24% of respondents. The share of "emmigration" as a source of income has decreased, while the share of self-employed people in total employed people has increased.

- *BORROWING*

Out of the total surveyed households, 26.8% (324 households) state that they currently have a debt to pay, up 2 percentage points from 2011 H1. The main source of debt for 54% (52% in Lek and 2% in foreign currency) of borrowers is a natural person and for 42% (39% in Lek and 3% in foreign currency) is a bank. Compared to the previous half of the year, there is a lower share of borrowing from natural persons and a higher one of borrowing from banks. Concerning the stated debt stock (outstanding debt), 54% accounts for formal debt[13] (144 borrowing households), while 41% accounts for potentially informal debt[14] (173 borrowing households).

Broken down by purpose of use, the purchase/restoration of a real estate remains the main purpose of household borrowing, accounting for 38% of the cases, consumption for 23% and business development for 10.8% of the cases. The first two items reduced their share in 2011 H2 compared to the previous quarter. The share of borrowers for consumption purposes pursued a gradual downward trend in the last three semesters, from 29% of the total in 2010 H2 to 24% in 2011 H2. Euroisation of household borrowing remains low (94% of borrowing is in Lek), mainly due to borrowing from natural persons. The remaining maturity for the settlement of the debt stock is mainly a mid-term period of 1-3 years (44%) and a short-term period of 12 months (28%).

Chart 2.5 Source and purpose of household borrowing



Source: Bank of Albania

[13] *Formal debt represents borrowing from banks and non-bank financial institutions.*
[14] *Informal debt represents borrowing from natural persons.*

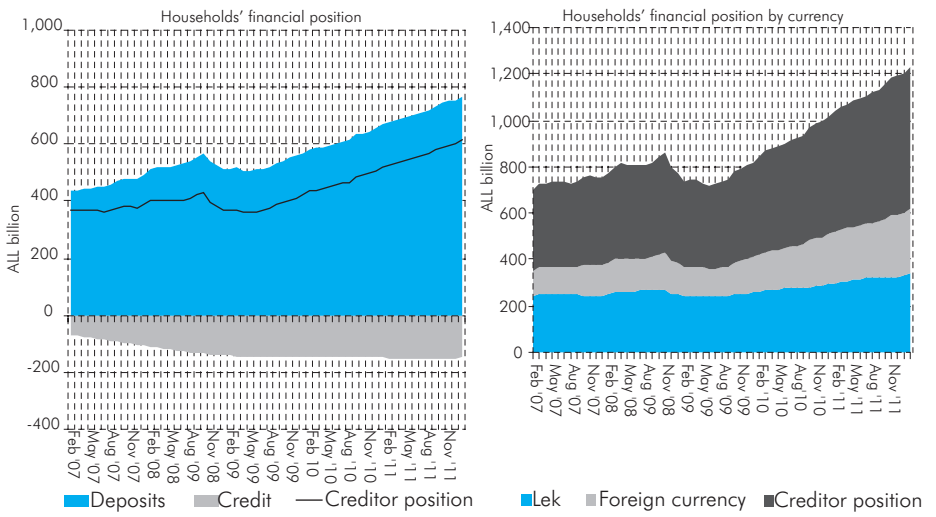
- *DEBT BURDEN FOR HOUSEHOLDS*

26% of borrowing households in this survey state that their solvency deteriorated in 2011 H2[15], mainly due to the lower household income and higher spending. In order to deal with their financial stress concerning the settlement of debt, in 60% of the cases, households cut back on their spending; in 20% of the cases, they seek a second job; and in 15% of the cases, they ask to renegotiate the terms and conditions of the debt. For 2012 H1, 78% of borrowing households do not expect any changes in their solvency, while 16% of them expect it to deteriorate, compared to 14% in the previous survey. Concerning the possibility of borrowing new debt in the next half of the year[16], about 60% of households responding to this question state that there is no possibility of borrowing new debt.

2.3.2 FINANCIAL POSITION

In December 2011, households' financial position as creditors of the financial system amounted to ALL 615 billion, up ALL 96.73 billion from the previous year. This development reflects the growth in household deposits by ALL 96.4 billion, while credit declined by ALL 380 million. Broken down by currency, households' financial position as creditors of the financial system in the Albanian Lek amounts to ALL 338.6 billion. Their creditor position in foreign currency amounts to ALL 276.8 billion. The latter increased more than that in Lek, by respectively ALL 56 billion versus ALL 39.8 billion in foreign currency. This performance reflects the faster growth of household deposits denominated in foreign currency versus those in Lek, and the lower foreign currency lending to households.

Chart 2.6 Households' financial position to the financial system



Source: Bank of Albania

[15] *69% of borrowing households stated that their solvency remained unchanged in the past half of the year; 26% stated that it worsened; and 5% stated that it improved.*

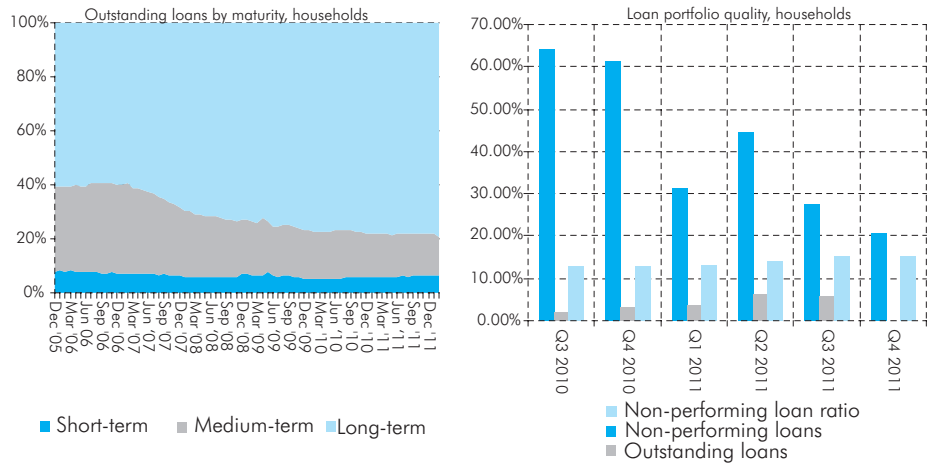
[16] *This question was addressed to the entire sample of households, but only 27% (330 households) of them responded to it.*

2.3.3 CREDIT RISK

During 2011 H2, outstanding household loans[17] manifested positive growth rates. Despite the slight annual increase by 0.5% in December 2011, the annual growth rate averaged 4.91% in 2011 H2, compared to 3.79% in H1. Worth noting during the period under review is the increase in the share of long-term loans, which accounts for 79.7% of total household loans, versus the share of medium-term loans, 14.2%, and short-term loans, 6.2%. In 2010 H2, long-term loans accounted for 77.8% of total household loans. Households also lowered their share in foreign currency borrowing, which in December 2011 accounted for 56.6% of the total, compared to 58.2% in December 2010.

The improvement in lending was also reflected in the household loan portfolio quality, which deteriorated at a slower pace than businesses' loan portfolio quality. In December 2011, the ratio of non-performing loans stood at 15.35%, compared to 13.91% in June 2011 and 12.74% in December 2010. The growth rate of this ratio by 2.62 percentage points during the 12-month period remains, however, a concern although the stock of non-performing loans increased at a slower pace than in the previous year. In the meantime, households' exposure to credit risk for 2012 remains present against a background of sluggish economic growth, moderate credit growth rate and heightened uncertainty related to economic activity.

Chart 2.7 Household loans



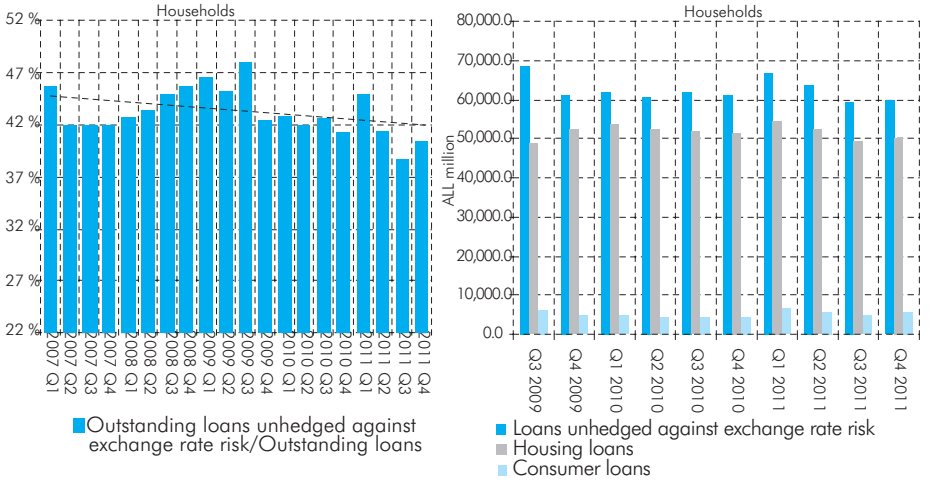
Source: Bank of Albania*
*Outstanding loans and non-performing loans are presented in terms of annual growth, while non-performing loan ratio is presented in terms of percentage.

2.3.4 INDIRECT CREDIT RISK ARISING FROM EXCHANGE RATE

Following the downward trend of households' exposure to indirect credit risk arising from exchange rate that began at end-2009, the ratio of loans unhedged against exchange rate risk accounted for 40.4% of total household loans (December 2011). The same ratio stood at 41.1% in the previous year.

[17] *Non-residents are excluded from the calculation of loans.*

Chart 2.8 Household exposure to indirect exchange rate risk



Source: Bank of Albania

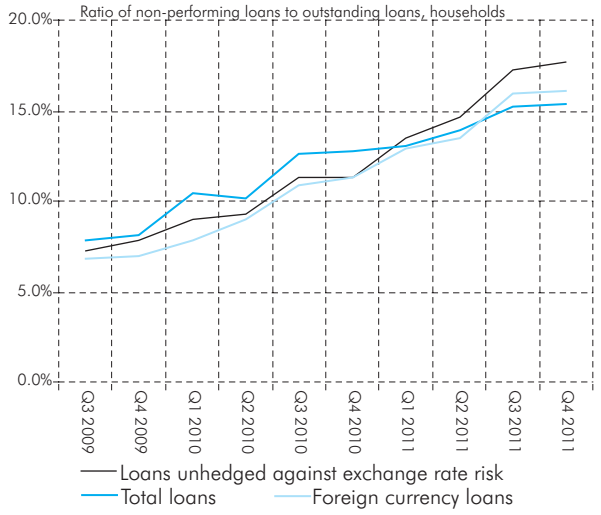
Housing loans account for about 83.7% of household loans unhedged against indirect credit risk arising from exchange rate. The average of this ratio stood at 82.5% in 2011, compared to 85.2% in 2010. The lower ratio in 2011 is rather a reflection of the decline in lending for house purchase purposes[18] than of the lower share of loans unhedged against this type of risk. However, although household loans for house purchase purposes are highly unhedged against indirect credit risk arising from the exchange rate, they are highly supported by collateral, thereby providing good hedging against the deterioration of portfolio quality for this type of loan.

The impact of indirect credit risk arising from the exchange rate Albanian households are exposed to is reflected in their portfolio quality. The latter deteriorated at a faster pace than the quality of total outstanding loan portfolio. In December 2011, loans unhedged against indirect credit risk arising from exchange rate, with repayment problems, rose to 17.7% of this item's stock compared to 16.1% for the total foreign currency loans and 15.35% for total household loans. The quality of the housing loan portfolio stands at 17.5%, deteriorating by 6.2 percentage points from the previous year.

The amount of household loans for house purchase purposes increased slightly in 2011. As at December 2011, the average amount of household loans for house purchase purposes denominated in foreign currency is ALL 2.4 million per borrower, compared to ALL 2.2 million in the previous year.

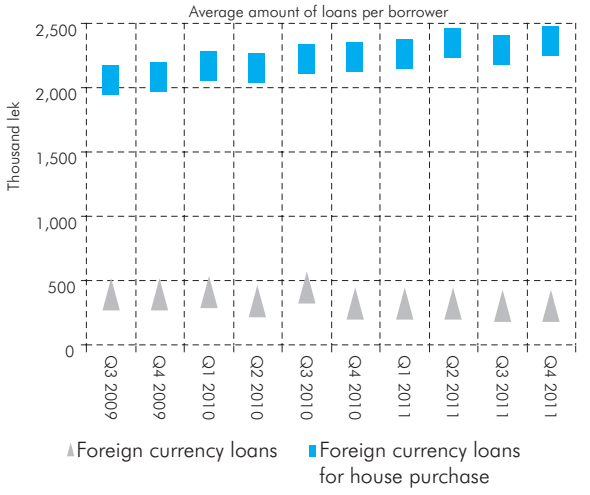
[18] *Foreign currency loans when borrower's income is in Lek.*

Chart 2.9 Household loan portfolio quality



Source: Bank of Albania

Chart 2.10 Average amount of household loans denominated in foreign currency



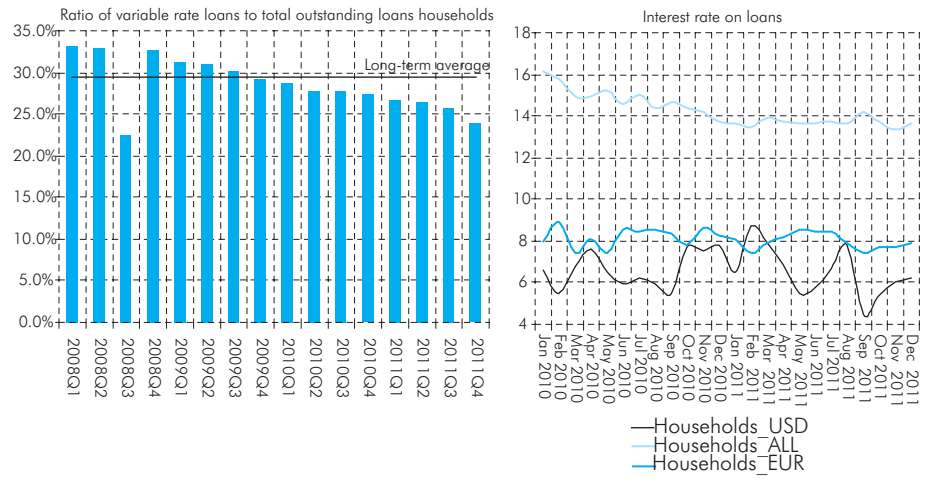
Source: Bank of Albania

The deterioration of the foreign currency loan portfolio quality reflects the significant impact of exchange rate moves on households' solvency when their income is in Lek. Although the annual exchange rate depreciation of Lek against euro averaged 2.2% in 2011, compared to 4.4% in 2010, the impact of its moves on households' financial position is significant.

2.3.5 INDIRECT CREDIT RISK ARISING FROM INTEREST RATE

Households' exposure to indirect credit risk arising from interest rate was lower in December 2011. The ratio of variable interest rate loans to total household outstanding loans reached 23.8%, compared to 27.4% in the previous year. The growth rate of variable interest rate loans is slower than that of household outstanding loans, thereby being reflected in the reduction

Chart 2.11 Household exposure to indirect interest rate risk



Source: Bank of Albania

of household exposure to this type of risk to below the long-term average. If this trend persists, the lower share of variable interest rate household loans – excluding factors related to the type of loan and its maturity structure – may reflect banks' expectation for the decrease of the interest rate in the foreseeable future.

The lower exposure to variable interest rate loans, coupled with the decrease in benchmark interest rates on loans in 2011[19], contributed positively to households' solvency. Consequently, indirect interest rate risk has been assessed as moderate. Concerning the outlook for 2012, the downtrend in T-bill interest rates is expected to be supported by the accommodative monetary policy at home against a background of contained inflationary pressures. On the other hand, several structural changes in market agents' demand for these instruments may induce volatility into the interest rate performance in the short run. Accommodative measures of monetary authorities in the international markets have reduced euro and US dollar interest rates to historical lows, and the uncertain expectations for the economic growth outlook suggest that the low interest rates will persist in the foreseeable future.

2.4 BUSINESSES' FINANCIAL SITUATION AND BORROWING

The slowdown in economic growth was reflected in the financial performance of businesses, which, however, report the easing of their financial situation in 2011 H2. Risks to financial stability related to business activity are higher than in the previous half of the year and need close monitoring. The rapid deterioration of the business loan portfolio quality remains the main risk to their activity and the banking sector. In addition, businesses have increased their exposure to adverse exchange rate and interest rate movements through variable cost loans.

2.4.1 SURVEY OF BUSINESSES' FINANCIAL SITUATION AND BORROWING

- *FINANCIAL SITUATION*

In order to assess the financial situation and borrowing of businesses operating in Albania, we analyse the survey results for 2011 H2.

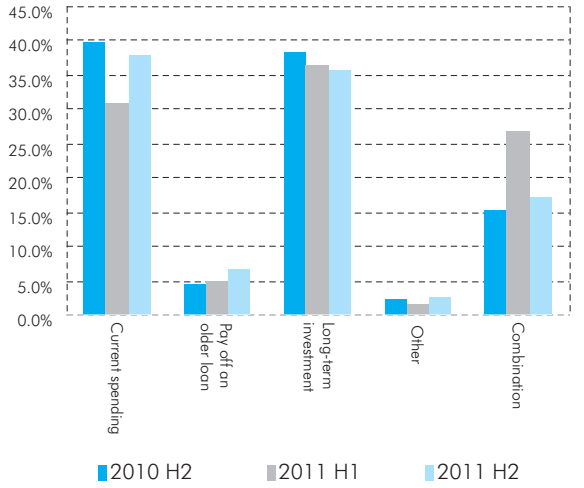
For the stated period, 32.9% of surveyed businesses (234 businesses) state that they expanded their activity or increased their investment, up by 5.5 percentage points from 2011 H1. The use of foreign currency decreased due to businesses' activity being carried out mainly in lek for 90.3% of businesses, about 1.5 percentage points higher than in the previous half of the year. In 2011 H2, businesses reported a higher average profit than in H1.

[19] *Mainly on 12-month T-bills.*

- *BORROWING*

Out of the total surveyed businesses, 49.9% (or 43.4% of the total sample) state that they actually have a loan to repay. This figure is 2.5 percentage points lower than in 2011 H1. Sales were the main funding source for the activity of 31.7% of the surveyed businesses, while borrowing as a separate or combined source of financing was used by 25.7% (183 businesses) of the surveyed businesses, down by 1.9 percentage points from the previous half. Broken down by sectors of economy, services sector-related businesses result with the highest percentage of financing through sales, 54.1% of responses. Construction remains the most financially dependent sector on borrowing from the banking sector, 8.3% of responses, despite the downward trend compared to the previous period.

Chart 2.12 Distribution of businesses by purpose of loan use



Source: Financial Stability Department

Out of the total surveyed businesses, 60.8% stated that they had borrowed short-time loans; 29.2% medium-term loans, and the rest, 10%, had borrowed long-time loans. For 38% of the surveyed borrowing businesses, the main purpose of borrowing was to cover their current spending, up 7 percentage points from the previous half. 35.7% of the surveyed businesses stated that the purpose of their borrowing was to make a long-term investment, almost similar to the previous period.

Average outstanding loans in Lek decreased over the stated period, thus increasing businesses' exposure to adverse exchange rate movements. Consequently, the euroization of borrowing increased for all the sectors of economy compared to the previous two periods. In the meantime, 74.4% of businesses stated that they had pledged collateral in the form of real estate, while collateral-free borrowing fell by 1.4 percentage points from the previous period.

- *DEBT BURDEN FOR BUSINESSES*

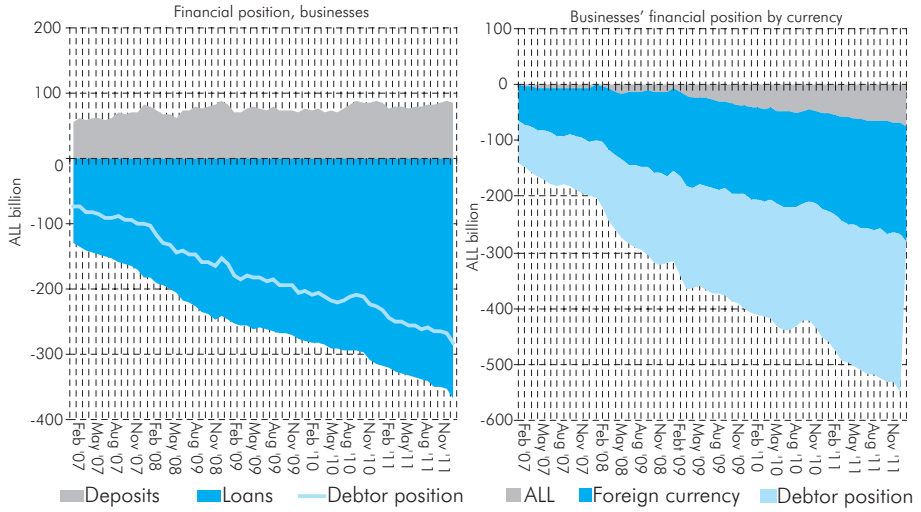
For 73.5% of surveyed businesses, the total loan amount accounts for about 50% of the capital or 6.3 percentage points more than in the previous half. The monthly spending on loan payment accounts for an average of 24.6% of their income. About 70% of businesses state that the monthly loan payment has increased in the last six months, mainly due to interest rate movements and lower operating income. Concerning the outlook, 66.3% of businesses state that they do not expect to apply for loans in the next six months.

2.4.2 FINANCIAL POSITION

In order to assess the impact of business activity on the financial system, we analyse their financial position and exposure to credit risk, exchange rate risk and interest rate risk.

As at December 2011, businesses' financial position as debtors in the financial system amounted to ALL 281 billion, up by ALL 53.4 billion from the previous year. This development reflects the high increase in business loans by ALL 51.6 billion, while business deposits contracted by ALL 1.8 billion. Broken down by currency, businesses' financial position as debtors of the financial system amounted to ALL 76.4 billion in Lek and ALL 204.7 billion in foreign currency. The debtor position in foreign currency expanded more than that in Lek by respectively ALL 29.45 billion and ALL 23.93 billion. This development reflects the decline in business deposits denominated in foreign currency compared to a year earlier, and the higher growth of foreign currency lending versus lending in the Albanian Lek.

Chart 2.13 Businesses' financial position



Source: Bank of Albania

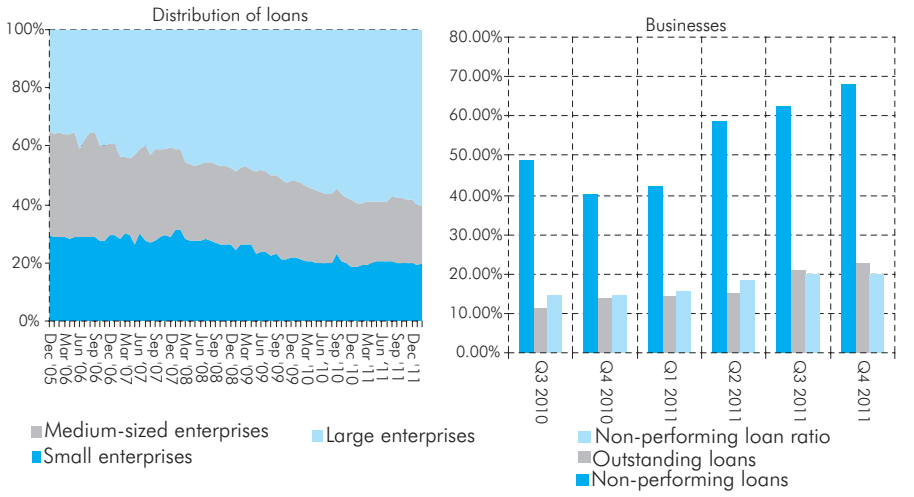
2.4.3 CREDIT RISK

As at December 2011, business loans grew at an annualised rate of 22.8%[20]. Lending to large enterprises grew at considerable rates, accounting for 60.3% of total lending. Lending to small and medium-sized enterprises accounts for 19.9% and 19.8%, respectively. Large enterprises have increased their share in long-term borrowing (30% of the total) although short-term borrowing continues to account for 51.7% of total loans. Small and medium-sized enterprises have mainly borrowed long-term loans, accounting for 47% of total borrowing for small enterprises and 40.8% for medium-sized enterprises.

[20] *Non-residents are excluded from the calculation of credit growth.*

Despite the positive credit developments, the quality of total business loan portfolio continued to deteriorate. The ratio of business non-performing loans to outstanding loans reached 20% in December 2011, compared to 18.5% in June 2011 and 14.6% in December 2010. The growth rate of this ratio by 5.4 percentage points over the 12-month period remains a concern considering that the stock of non-performing loans expanded at a faster rate than in the previous year (up 68.2% y-o-y in 2011), while outstanding loans grew at a slower rate.

Chart 2.14 Business loans and loan portfolio quality



Source: Bank of Albania*

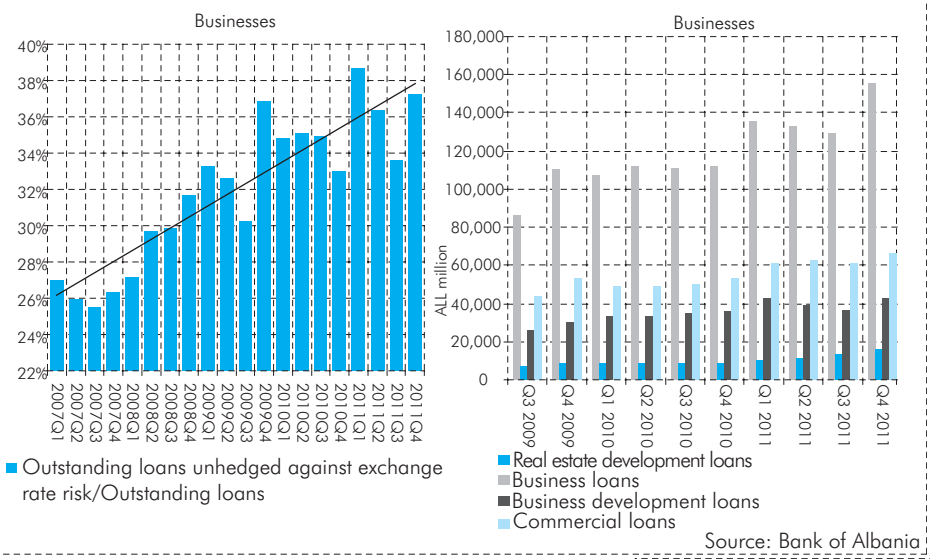
*Outstanding loans and non-performing loans are presented in terms of annual growth, while non-performing loan ratio is presented in terms of percentage.

Making a comparison between the performance of business loan portfolio quality and household loan portfolio quality, we note that the deterioration of the former is growing at a faster rate and remains very high. Banks' inclination to expand the business loan portfolio more than the household one, may reflect their need for lending for restructuring purposes.

2.4.4 INDIRECT CREDIT RISK ARISING FROM EXCHANGE RATE

Although in December 2011 business borrowing in foreign currency accounted for 70.4% of the total compared to 73.7% in the previous year, there is higher exposure to indirect exchange rate risk. The ratio between loans unhedged against indirect credit risk arising from exchange rate and business outstanding loans stood at 37.2%, about 4.2 percentage points higher than in 2010. The higher ratio reflects the growth of loans unhedged against exchange rate risk by 39% y-o-y, while outstanding loans have increased by only 22.8%. Despite the more moderate exchange rate depreciation of the Lek versus the euro than in the previous year, the growing trend of businesses borrowing in foreign currency unhedged against exchange rate risk remains a concern.

Chart 2.15 Business exposure to exchange rate risk



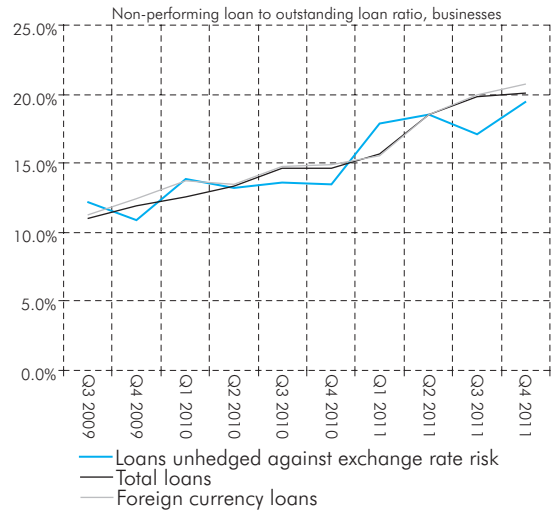
Source: Bank of Albania

Over the same stated period, 43% of business loans unhedged against indirect credit risk arising from exchange rate represents commercial loans, down by 4 percentage points from the previous year. However, the average of this ratio for 2011 is similar to that in 2010 (about 46%). Business development loans unhedged against indirect credit risk arising from exchange rate accounts for 27.7% of the total and about 4.2 percentage points less than in the previous year. Exposure to exchange rate fluctuations is higher for real estate business loans, accounting for 10.4% of the total, compared to 7.5% in 2010.

Despite the increasing exposure of businesses to loans unhedged against indirect credit risk arising from exchange rate, the deterioration of quality was slower in 2011 H2 than in H1. As at December 2011, the ratio of non-performing loans in foreign currency for loans unhedged against indirect credit risk arising from exchange rate stood at 19.4% versus 20.74% for foreign currency loans and 20.04% for total business loans. The quality deteriorated for all items of business loans denominated in foreign currency.

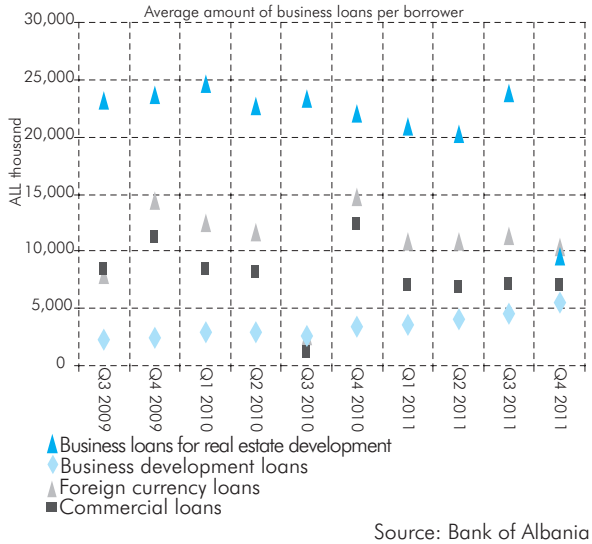
More specifically, non-performing loan ratio for commercial loans denominated in foreign currency stands at 15%. The same ratio stands at 27% for loans for business purposes. These ratios stood at 9% and 20%, respectively, in the previous year. Compared to households where the loan portfolio

Chart 2.16 Business loan portfolio quality



Source: Bank of Albania

Chart 2.17 Average amount of business loans denominated in foreign currency



Source: Bank of Albania

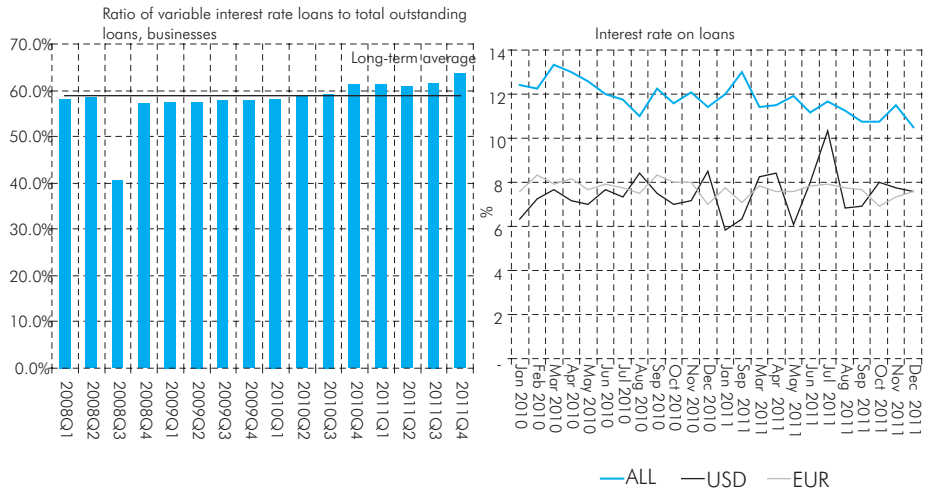
quality stands at better levels for housing loans to total loans denominated in foreign currency, the situation appears different for businesses. Non-performing loan ratio is 37% for real estate loans, compared to 10% in 2010. This development reflects the increase in the stock of non-performing loans for real estate purposes by 383%, while outstanding loans for this purpose expanded at an annualised rate of 32.5%. The high increase in non-performing loan stock for real estate purposes reflects the negative developments in the construction sector, since businesses use this type of loan for real estate development.

The deterioration of the foreign exchange loan portfolio quality was reflected in the reduction of the average amount of business loans. In December 2011, the amount of loans for real estate development purposes averaged ALL 9.56 million versus ALL 22 million in 2010[21]. Commercial loans have also been showing a declining tendency, while the average amount of business development loans increased to ALL 5.6 million from ALL 3.6 million in 2010.

2.4.5 INDIRECT CREDIT RISK ARISING FROM INTEREST RATE

Businesses' exposure to indirect credit risk arising from interest rate increased in December 2011. The ratio of variable interest rate loans to total outstanding loans reached 63.5%, compared to 61.2% in the previous year. This ratio has recorded rates above its long-term average since 2010 Q4.

Chart 2.18 Business exposure to indirect interest rate risk



Source: Bank of Albania

Although business lending grew at a faster rate than household lending, the decrease in interest rates did not progress along the same line. During 2011, the average interest rate on business loans in Lek decreased by 0.7 percentage points versus the decrease by 1.14 percentage points for

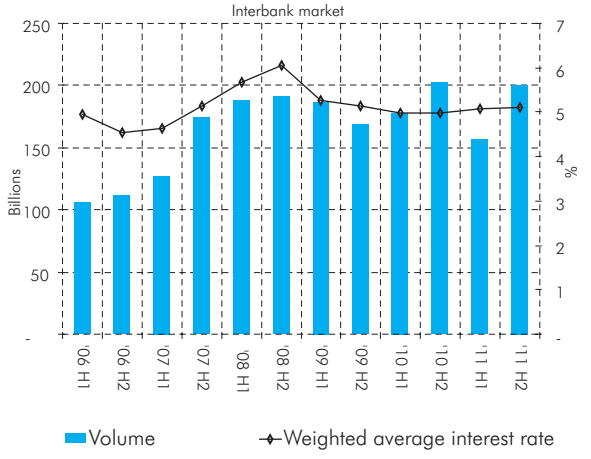
[21] *In December 2011, business loans for real estate purposes grew by 32.5%, while the number of borrowers doubled.*

households. Concerning euro-denominated business loans, the average interest rate dropped by 0.11 percentage points versus the drop by 0.14 percentage points for households. These developments provide evidence that although banks have lent more to businesses than to households, the cost of business loans has reduced at slower rates. The higher share of variable interest rate loans is beneficial to businesses in the short run as long as the interest rates are low or downward. In the long run, however, businesses' debtor position generates higher exposure to indirect credit risk arising from adverse interest rate moves.

III. FINANCIAL MARKETS

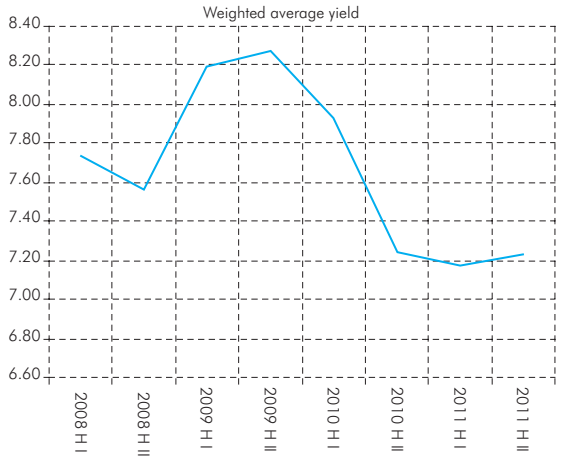
The Albanian financial market is dominated by operations in the interbank market, government debt securities and foreign exchange.

Chart 3.1 Interbank market volume and interest rates



Source: Bank of Albania

Chart 3.2 Average yield on debt securities



Source: Bank of Albania

3.1 INTERBANK MARKET

In 2011 H2, the volume of interbank market transactions increased by 28.4% compared to H1, while the weighted average interest rate stood at 5.12%, close to the previous half's level of 5.07%. Compared to 2010 H2, the interbank market volume fell by 0.7%, while the average interest rate increased by 0.14 percentage points.

3.2 PRIMARY SECURITY MARKET

In 2011 H2, the volume of government debt securities fell by 14.7% versus H1 to ALL 185.6 billion. This downtrend reflects the lower government demand for borrowing in the second half of the year. Debt issued in the primary market consists of T-bills (85.3%) and bonds (14.7%).

Yield on debt securities averaged 7.23% over the period under review, up by 0.05 percentage points from 2011 H1 and down by 0.01 percentage points from 2010 H2.

Over the same stated period, the volume of issued T-bills dropped to ALL 158.4 billion from ALL 182.8 billion in H1. The value of issued T-bills reduced by 13.4% versus 2011 H1 and was 16.1% lower than in 2010 H2. Concerning the composition of issued T-bills, 12-month and 6-month T-bills account for 54.4% and 28.0%, respectively, of the total, while 3-month T-bills account for 17.6%. The average cost of debt issued in T-bills has been falling in the last two years. The average yield on T-bills dropped slightly by 0.03 percentage points versus 2011 H1 and 0.08 percentage points versus 2010 H2.

The primary bond market also registered a decline to ALL 27.2 billion in 2011 H2. Expressed in terms of growth, the volume of bonds traded in H2 is 21.7% lower than in H1 and 3.6% lower than in 2010 H2. The composition of bonds consists mainly of 2-year bonds, accounting for 63.4% of the total, 3-year bonds, accounting for 6.4% of the total, and 5-year variable rate bonds, accounting for 30.2% of the total primary bond market in 2011 H2. Compared to 2011 H1, the share of 5-year variable rate bonds is higher while that of 3-year bonds is lower. The average yield on bonds increased by 0.61 percentage points versus 2011 H1 and by 0.22 percentage points versus 2010 H2.

Chart 3.5 shows the yields on securities over the last three semesters by maturity structure.

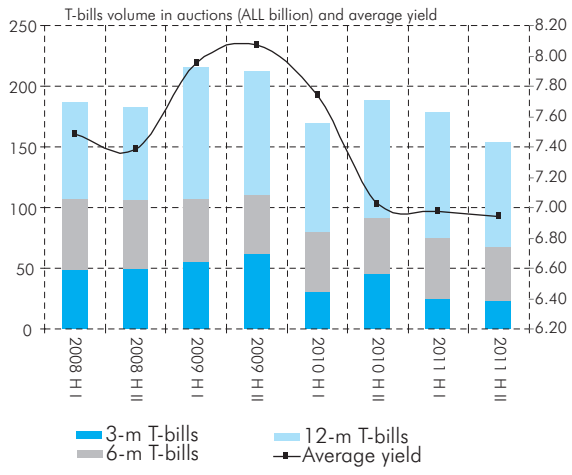
3.3 SECONDARY SECURITY MARKET

The volume of securities traded in the secondary market increased by 20.8% in 2011 H2 versus 2011 H1, while decreasing by 2.5% versus 2010 H2. 12-month T-bills have the largest share in securities traded in the secondary market, accounting for 96.2% of the total.

3.4 FOREIGN EXCHANGE MARKET

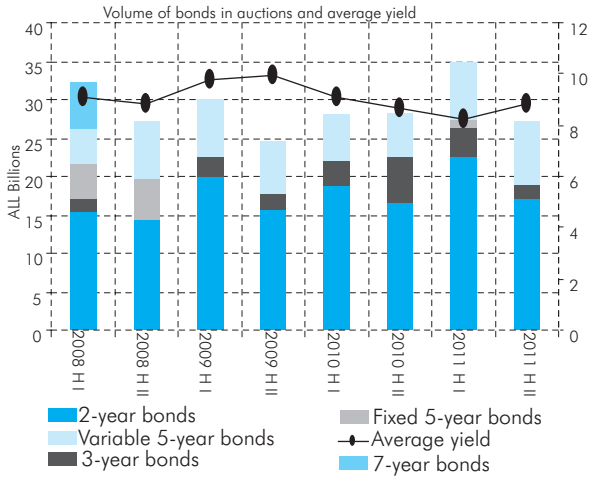
The performance of Lek in 2011 H2 was generally in line with the developments in the international foreign exchange markets. In November and December 2011, Lek appreciated against the Euro, reflecting – in addition to the year-end seasonal effect – the unstable Euro in the international markets due to euro area's concerns. In December 2011, the Lek appreciated by 0.4% against the Euro, while, for the entire year, the Lek depreciated by an average of 2.2% y-o-y. The Albanian Lek reflected an opposite performance against the US dollar. In December 2011, Lek depreciated by 0.1% against the US dollar, while, for the entire year, it appreciated by an average of 2.8%.

Chart 3.3 T-bills yield and volume in the primary market



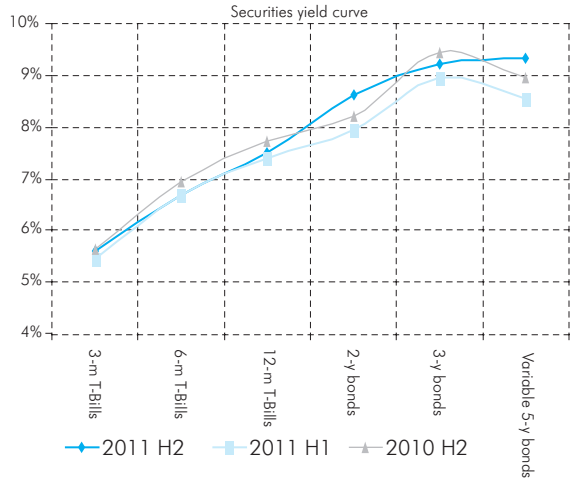
Source: Bank of Albania

Chart 3.4 Bond auctions



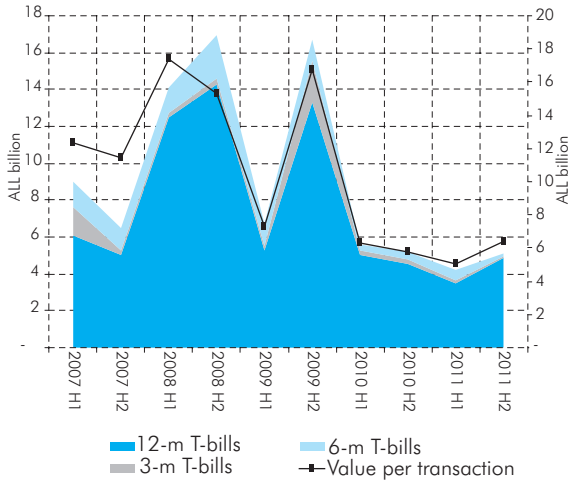
Source: Bank of Albania

Chart 3.5 Yield curve



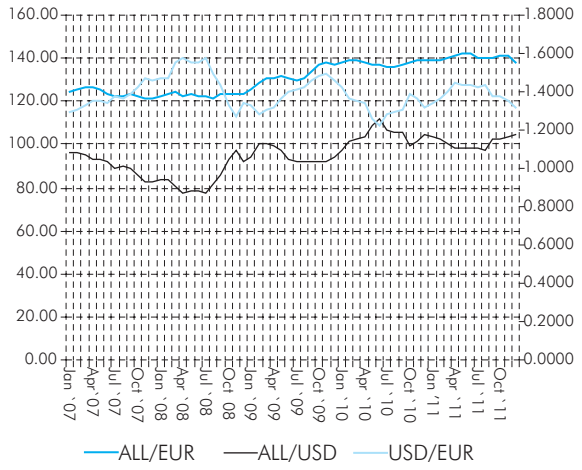
Source: Bank of Albania

Chart 3.6 Volume of T-bills traded in the secondary market



Source: Bank of Albania

Chart 3.7 Exchange rate for the three major currencies



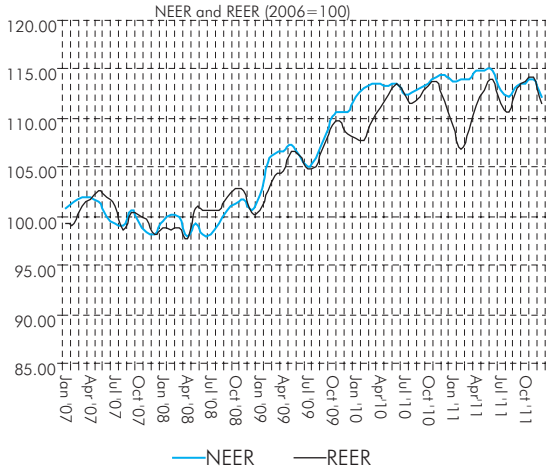
Source: Bank of Albania

Lek's Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER), which are constructed based on Albania's share of trade with Greece, Italy, Turkey, China and Germany, showed low volatility, reflecting the changes in supply and demand ratios in the Albanian forex market and the seasonal effect, particularly at the end of the year.

3.5 INTEREST RATE SPREAD BETWEEN NEW LOANS AND DEPOSITS

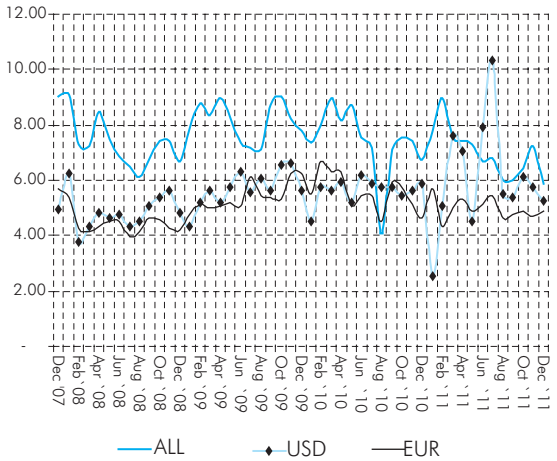
During 2011 H2, the interest rate spread between loans and deposits narrowed for the three major currencies, by 0.8 percentage points for operations in Lek, 2.7 percentage points for operations in US dollar and 0.24 percentage points for operations in Euro. This change was mainly driven by the decrease in the interest rates on loans denominated in these three currencies.

Chart 3.8 Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER)



Source: Bank of Albania

Chart 3.9 Spread between loans and time deposits, in %



Source: Bank of Albania

IV. PAYMENT SYSTEMS DEVELOPMENTS DURING 2011 H2[22]

4.1 PAYMENT SYSTEMS PERFORMANCE AND EFFICIENCY

The two payment systems operated by the Bank of Albania, AIPS[23] and AECH[24], reflected stable performance in 2011. In the absence of extraordinary situations, they operated without displaying any significant deviations from the settlement and clearing schedules, thereby reflecting a stable basic infrastructure of the national payments in Lek.

Table 4.1 Number and total value of payments processed in AIPS/AECH systems

	January-December 2010		January-December 2011	
System	AIPS	AECH	AIPS	AECH
Number of transactions	80,356	332,777	75,269	388,208
Value of transactions (in millions of ALL)	4,436,661.54	43,976.43	4,085,059.24	64,097.88
Average value per transaction (in millions of ALL)	55.21	0.13	54.28	0.17

Source: Bank of Albania

Compared to 2010, the number and value of transactions processed in the AECH system increased in 2011, while those processed in the AIPS decreased. The uptrend in the number and value of transactions cleared in the AECH system, to a considerable degree, reflects the measures taken by the Bank of Albania to expand the functioning of this system[25] in March 2011. On the other hand, the decline by 7.92% in the value of transactions settled in the AIPS was driven by the decrease in almost all types of transactions processed and settled in this system, with "BoA's financial instruments" providing the major contribution. The major reasons behind the decline in transactions processed in the AIPS are the increase in the threshold value of transactions cleared in the AECH system and the lower use of Bank of Albania's financial instruments.

4.2 DEVELOPMENTS IN PAYMENT INSTRUMENTS

As at end-2011, statistics obtained from banks' reportings show that customer payments increased both in terms of number and value. Out of total customer payments, Lek payments account for 86% in terms of volume and 53.3% in terms of value. In addition, credit transfers continue to have a

[22] *This section is based on data processed and materials prepared by the Payments Systems Department, Bank of Albania.*

[23] *AIPS - Real Time Gross Settlement System.*

[24] *AECH - Automated Clearing House System.*

[25] *Concerning the AECH system, these measures consist in: raising the threshold of transactions processed and cleared in the AECH system from ALL 1 million to ALL 1.5 million, increasing the total number of clearing sessions to 3, associated with measures oriented towards the reduction of costs in March 2011.*

dominant share (79%), while card-based payments and direct debit payments (intra-bank) share 10% of total payments. In terms of volume and value, paper-based credit transfers share 97%, while electronic payments remain at low levels, accounting for about 2.94% of the total.

Compared to 2010, cards in circulation increased in 2011; however, the growth rate fell to 5.3% from 23% in the previous year. The increase in the number of cards was higher for credit cards (38%) than for debit cards (4%). The latter, however, account for 95% of total cards issued.

Concerning the infrastructure offered by banks licensed to issue cards and accept cards, it is noted that the number of ATMs and POSs increased by respectively 4.4% and 4.5% at end-2011 compared to end-2010. In a regional context, despite the rapid growth rates of ATMs and POSs in Albania, this infrastructure is considerably more limited than in most countries in the region.

The use of electronic payment instruments – and of home banking in particular – has been increasingly expanding in Albania recently. As at end-2011, home banking was provided by 11 banks, in the form of products allowing remote access into the bank account.

The performance of the value and number of home banking transactions during 2005-11 provides evidence for a higher increase in the number of transactions compared to their value, which may reflect the expanded use of this instrument to a wider range of users.

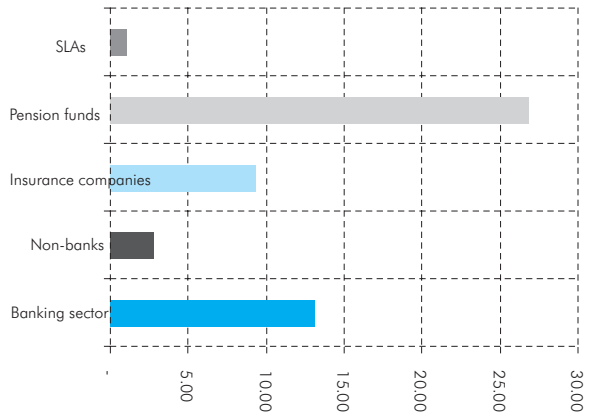
V. FINANCIAL SYSTEM DEVELOPMENTS

Despite the slowdown in economic growth in Albania, the financial developments were generally positive in 2011. The banking sector is well-capitalised and liquid. Non-bank financial institutions, savings and loan associations and insurance companies expanded their activity further. Revenues and contributions to the voluntary private pension market increased in 2011. Credit risk remains the major risk to credit institutions, thus impacting on the fall of profit as well.

The level of financial intermediation in Albania, measured as the ratio of financial system assets[26] to GDP, was estimated at 89.4% in 2011 H2, from 86.9% in H1 and 85.9% in the same period in 2010. The volume of financial institutions' assets grew by about 12.5% compared to the previous year.

The banking sector remains the dominant segment of financial intermediation in Albania. Its assets account for about 94.7% of total financial system assets and about 84.7% of GDP.

Chart 5.1 Annual change of assets in individual financial system segments, in %



Source: Bank of Albania

Table 5.1 Financial system segments as a percentage of GDP across the years

Licensing and Supervisory Authority	Financial System	Years					
		2006	2007	2008	2009	2010	2011
Bank of Albania	Banking sector	69.6	75.9	76.7	77.5	80.9	84.7
	Non-bank institutions	1.52	1.48	1.66	2.2	2.7	2.6
	SLAs and their Unions	0.52	0.63	0.7	0.77	0.78	0.74
Albanian Financial Supervisory Authority	Insurance Companies	1.29	1.36	1.45	1.5	1.4	1.4
	Pension Funds	-	-	-	0.01	0.01	0.01

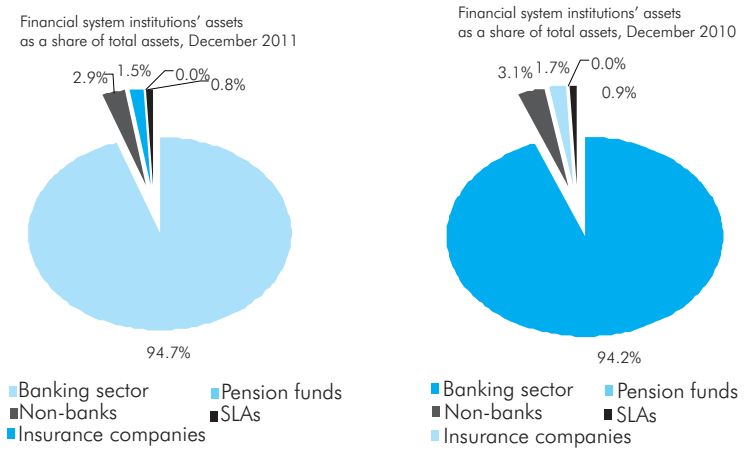
Source: Bank of Albania, Albanian Financial Supervisory Authority

Non-bank financial sector continues to share a relatively small weight in total financial system. Total non-bank financial sector assets[27] account for about 5.3% of the financial system, hence down from 5.7% at end-2010. Non-bank financial sector activity accounts for about 4.7% of Albania's GDP, compared to 4.9% at end-2010.

[26] *The financial system consists of banks, non-bank financial institutions, savings and loan associations, insurance companies and supplementary private pension funds.*

[27] *The data on non-bank financial institutions and SLAs refer to 2011 Q4, while those on insurance companies and pension funds refer to 2011 Q3. Information on total pension funds assets was obtained from the latest AFSA's release, December 2011.*

Chart 5.2 Financial system institutions' assets as a share of total assets



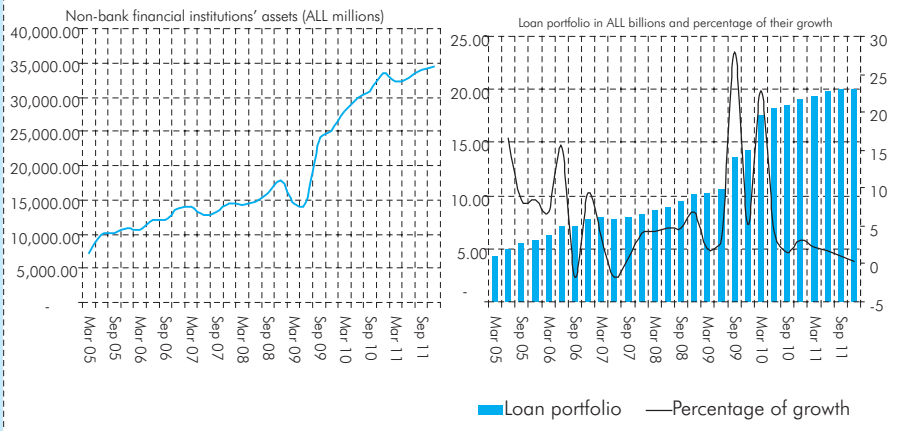
Source: Bank of Albania

BOX 5 NON-BANK FINANCIAL SECTOR

- *Activity of Non-Bank Financial Institutions*

Non-bank financial institutions are licensed and supervised by the Bank of Albania. As at 2011 Q4[i], their assets amounted to ALL 34.4 billion, up about ALL 1.6 billion (or 4.8%) from 2011 H1 and ALL 924 million (or 2.77%) from the same period in 2010. Lending activity has the main share in non-bank financial institutions' activity, about 58.3% of total assets.

Chart 5.3 Non-bank financial institutions' assets and loan portfolio

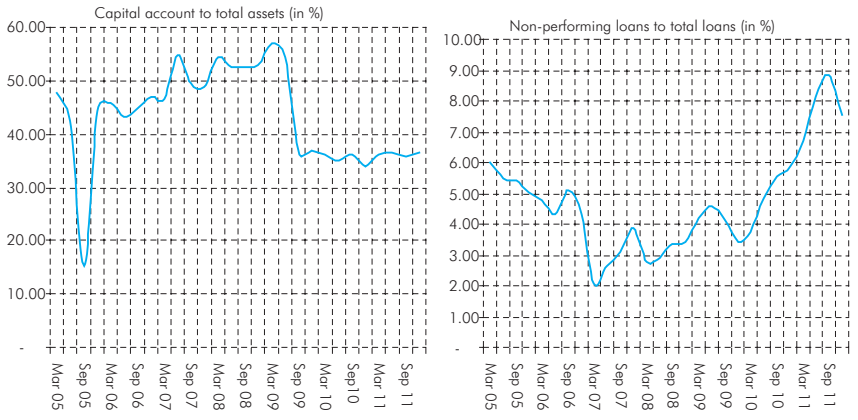


Source: Bank of Albania

Capitalisation, measured as the ratio of capital account to total assets, rose to 36.5% in 2011 Q4, very close to the level of June 2011 and higher than in the same period in 2010 when it stood at 33.7%. The loan portfolio quality for non-bank financial

institutions deteriorated further compared to the same period in 2010; however, improving relative to 2011 H1. Consequently, the ratio of non-performing loans to total loans for non-bank financial institutions reached 7.6% in December 2011, from 8.1% in June 2011 and 5.9% at end-2010. This indicator is also considerably above its historical average[ii] of 4.6%.

Chart 5.4. Capital adequacy ratio and non-performing loan ratio



Source: Bank of Albania

Profit of non-bank financial institutions increased in 2011 Q4. Net profit was estimated at about ALL 1.1 billion, compared to about ALL 978.9 million in the same period in 2010. Income for the same stated period amounted to ALL 7.1 billion versus ALL 6.7 billion in 2010. Income from commissions, which rose to ALL 1.2 billion versus ALL 790.3 million in 2010, provided the major contribution to their increase.

- *Activity of Savings and Loan Associations (SLAs)*

In 2011 Q4, SLAs registered positive developments in terms of asset and loan portfolio growth versus the previous year. They also recorded a positive profit, albeit lower than in 2010, and an improved loan portfolio quality.

Table 5.2 Selected indicators of SLAs and their unions

	QI-10	QII-10	QIII-10	QIV-10	QI-11	QII-11	QIII-11	QIV-11
Total assets (ALL mln)	8,825	9,378	9,581	9,705	9,605	9,649.57	9,602.84	9,808.68
Outstanding loans (ALL mln)	7,003	7,125	7,124	7,072	7,026	6,946.58	6,909.23	7,118.68
Outstanding loans/total assets (%)	79.4	75.9	74.4	72.8	73.2	71.99	71.95	72.58
Non-performing loans (ALL mln)	198.8	237.1	262.6	357.9	270.2	315.11	392.10	315.65
Non-performing loans/ outstanding loans (%)	2.84	3.3	3.69	5.06	3.85	4.54	5.68	4.40

Source: Bank of Albania

SLAs and their unions registered a profit of ALL 82.6 million in 2011 versus ALL 232.2 million in 2010.

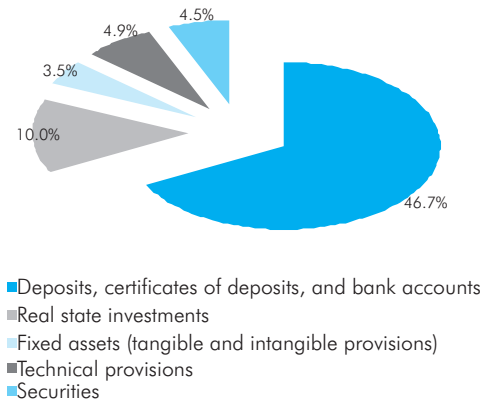
- *Activity of Insurance Companies and Private Supplementary Pension Funds*

The insurance market[iii] expanded gradually in 2011 in terms of assets, income from insurance premiums, increase in new contracts and maintenance of a satisfactory level of capitalisation. Profitability was, however, lower than in 2010, hence causing the insurance companies to pay out less in claims. The insurance market continues to remain oriented towards non-life insurance.

In 2011, income from insurance premiums amounted to about ALL 8,356 million or 1.8% higher than in 2010. Paid claims fell by 4.3% in 2010, with claims for motor vehicle insurance sharing the main weight, 78.1%. Consequently, claim/premium ratio, which also measures the insurance market penetration in the financial system, stood at 26%, on a national level, compared to 28% in 2010. In terms of market share by type of insurance, voluntary insurance shares 55.3%, while compulsory insurance shares 44.7% of total market.

Chart 5.5 Share of insurance companies' asset items

Share of insurance companies' asset items to total assets, in %, 2011 Q3



Source: Bank of Albania

Insurance sector's assets amounted to about ALL 18.2 billion in 2011 Q3[iv], increasing slightly by ALL 207 million (or 1.1%) from end-2010, and by about ALL 1.5 billion (or 9.4%) from the same period in 2010. Deposits, certificates of deposit and bank accounts have the largest share in total insurance companies' assets, by about 46.7%.

Capital to technical provisions ratio, which measures the capacity to cover losses incurred from exposure to potential risks, stood at nearly 158.4% in 2011 Q3 versus 168.7% at end-2010, which is, however, higher than in 2010 Q3 when it stood at 140.4%. The uptrend in this ratio signals higher absorption of losses arising from the insurance activity.

Insurance companies registered a profit of ALL 540.4 million in 2011 Q3 versus ALL 843 million in the same quarter in 2010. The lower profit was also reflected in the two return indicators: RoA and RoE, which in 2011 Q3 stood at 3.1% and 5.6%, respectively, compared to 5% and 9.7% in the same quarter in 2010.

Private supplementary pension market[v] expanded with two operators licensed in 2011, which are expected to develop this segment further. Total assets of private supplementary pension market amounted to ALL 142 million. Total income from contributions totalled ALL 177 million, of which about 44% is paid by the members and the rest by the employers.

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i Albanian Post Office has not reported its balance sheet as at 31 December 2011 yet, hence our calculations consider its balance sheet as at 30 September 2011.

ii The historical average of NPLs for non-bank financial institutions covers the period from December 2005 to December 2011.

iii According to the AFSA's statistical release "Insurance Market for 2011".

iv According to reportings to the Bank of Albania.

v According to AFSA's publication "On Developments in Private Supplementary Pension Market for 2011".

VI. BANKING SECTOR

6.1 ASSET AND LIABILITY PERFORMANCE AND THEIR RESPECTIVE COMPOSITION

As at end-2011, banking sector assets accounted for 84.8% of GDP, from 82.2% as at the end of 2011 H1 and 80.9% as at end-2010. The banking sector assets totalled ALL 1,120.2 billion, up 7.3% from 2011 H1 and 13.1% from end-2010.

Table 6.1 Share of asset items (December 2005-December 2011)

As a share of total assets (in %)	December 2005	December 2006	December 2007	December 2008	December 2009	December 2010	December 2011	In ALL billions (December 2011)
1. Treasury and interbank transactions, of which:	58.8	50.6	39.5	30.1	28.7	29.9	29.8	333.2
- Transactions with the Central Bank	9.3	8.9	9	8.3	7.8	8.3	8.1	91.2
- T-bills	35.3	26.3	17.1	12.8	12	10.4	9.3	104.6
- Transactions with other banks	12.2	13.2	11.2	6.6	6.5	9.3	10.5	117.6
2. Operations with customers (gross)	25.7	31.7	39.4	47.6	50.8	49.1	50.1	561.7
Provisions	-0.36	-5.45	-6.24	-1.51	-2.83	-3.77	-5.2	-58.8
3.Securities transactions	12.2	14.7	18	20	20.1	21.27	21.8	244.2
4. Other assets	0.7	0.9	1.3	1	0.9	0.92	1.2	13.8
5. Fixed assets	1.5	1.5	1.5	1.8	1.7	1.4	1.2	13.9
Accrued interests (total)	1.6	1.27	1.32	1.3	1.18	1.19	1.1	12.2
Total assets	100	100	100	100	100	100	100	1120.2

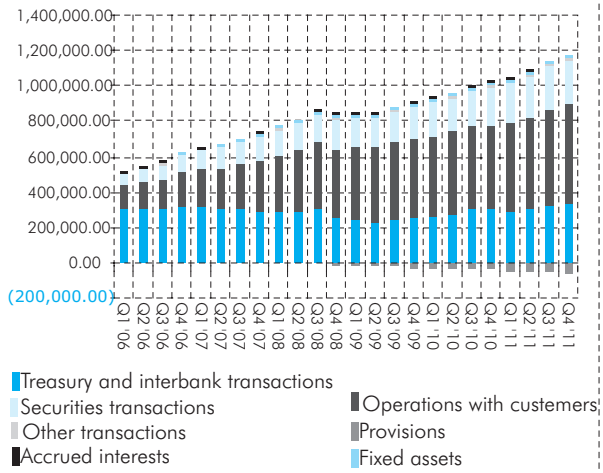
Source: Bank of Albania

Banking sector asset composition highlights:

- In 2011 H2, loan portfolio (excluding accrued interests[31]) amounted to ALL 561.7 billion, up 8.3% from 2011 H1 and 15.5% from the previous year. The growth in the stock of loans resulted higher in 2011 than in 2010 (9.1%). Foreign currency loans accounted for 67.9% of total loans, down 0.8 percentage points from 2011 H1. The share of banks peer group 3 accounted for 67.7% of total loan portfolio.

- Treasury and interbank transactions (excluding accrued interests) recorded ALL 333.2 billion, up 8.9% from June 2011 and 12.5% from the previous year. This item's growth rate was 11.8% over December 2009 – December 2010, almost similar to end-2011's figures. The banks peer group 3 accounted for 74.1% of total treasury and interbank transactions.

[31] *Estimated at about ALL 4.5 billion.*



Source: Bank of Albania

- Banking sector investments in private and public debt securities, both domestic and foreign, totalled ALL 244.2 billion, or up 6.1% from 2011 H1 and 15.9% from the previous year. The banks peer group 3 accounted for 84.6% of total investments.

Chart 6.1 shows the composition and performance of asset items.

The share of banking sector liability composition has changed through the years as follows:

Table 6.2 Share of liability items (December 2006-December 2011)

As a share of total liabilities (in %)	December 2006	December 2007	December 2008	December 2009	December 2010	June 2011	December 2011	In ALL billions (December 2011)
1. Treasury and interbank transactions, of which:	7.6	5.7	11.8	4.5	6.18	6.75	6.4	72.1
- Transactions with the Central Bank	0.2	0	0.1	0.2	0.05	0.06	0.2	1.8
- T-bills	1.4	0.2	2.4	3.6	1.31	2.28	2.3	25.4
- Interbank transactions	4	5.3	9	4.3	4.7	4.3	1.45	16.3
2. Operations with customers (gross)	84.2	84.9	77.3	88.1	81.27	80.7	81.4	911.2
3. Other liabilities	0.8	1	1.1	1	0.76	1	0.9	10.2
4. Accrued interests	0.86	1.14	1.4	1.22	1.21	1.4	1.2	13.3
4. Permanent resources, of which:	7.4	8.4	9.6	10.8	10.58	10.1	10.1	113.4
- Shareholders' equity	6.8	7.5	8.6	9.6	9.4	8.6	8.7	97.3
Total liabilities	100	100	100	100	100	100	100	1120.2

Source: Bank of Albania

Banking sector liability composition highlights:

- Deposits (excluding accrued interests[32]) totalled ALL 911.2 billion, up 8.2% from 2011 H1 and 13.2% from the previous year. Banks peer group 3 accounted for 74.1% of total deposits;

- Treasury and interbank transactions[33] totalled ALL 72.1 billion. At the end of the period, their volume increased by ALL 1.7 billion, or up 2.4% from June 2011 and 17.8% from the previous year.

[32] *Estimated at ALL 12.8 billion.*

[33] *"Treasury and interbank transactions include: transactions with the Central Bank, T-bills sold through repurchase agreements and transactions with (borrowings from) foreign banks (mainly of the banking group they belong to).*

6.2 BANKING SECTOR POSITION TO NON-RESIDENTS

Banking sector assets to non-residents or banking sector investments in non-resident assets amounted to ALL 183.3 billion, up 41.7% from 2011 H1 and 50.2% from the previous year. At the same time, banking sector placements with non-resident institutions totalled ALL 98.2 billion, of which ALL 86.7 billion in the form of current and deposit accounts and ALL 11.5 billion in the form of loans. Non-resident assets to total assets amounted to 16.4%, from 12.4% as at the end of 2011 H1, up 4.1 percentage points from the same period a year earlier.

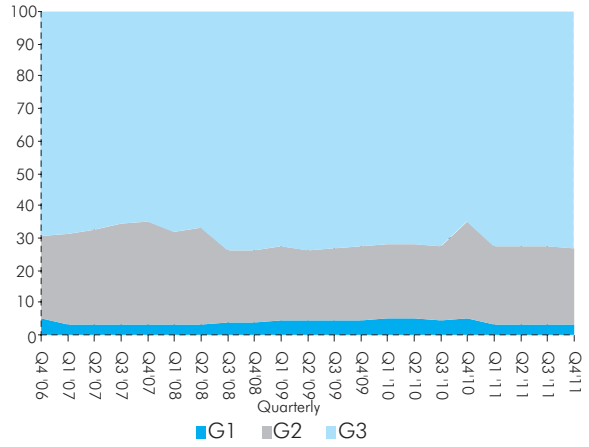
Banking sector liabilities to non-residents totalled ALL 76.3 billion, up 15.1% from June 2011 and 57.6% from the previous year. The value of committed and used proportion of credit lines from bank holding companies was about ALL 16.9 billion. The value of committed and unused proportion[34] of credit lines from bank holding companies was ALL 46.5 billion. The ratio of liabilities to non-residents to total liabilities was 6.8%, from 6.3% as at end-June 2011 and 4.9% on a year earlier. Banks peer groups 2 and 3, which are more exposed to non-resident institutions, have significantly influenced the ratio of liabilities to non-residents to total liabilities. In spite of this ratio's increase in 2011 H1, the situation appears normalised, thus reflecting a stable financial position.

As at end-2011, the ratio of liabilities to non-residents to total foreign currency liabilities was 13.1%, from 12.6% as at end-June 2011 and 9.6% on a year earlier. The above analysis reveals that the risk from banking sector exposure to non-residents is at moderate levels.

6.3 OUTSTANDING LOANS

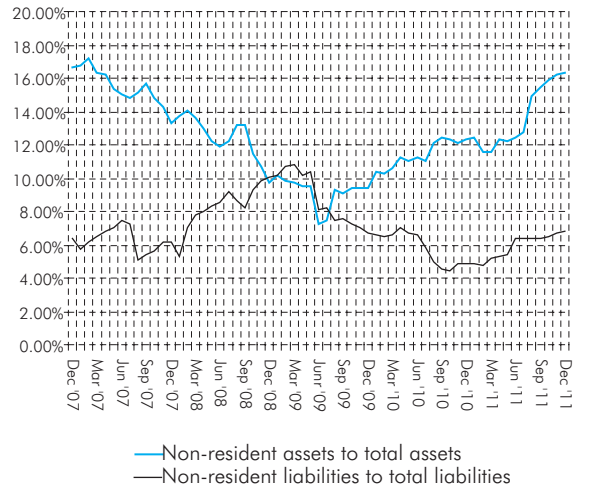
Banking sector's outstanding loans increased in 2011 as compared to the previous year. Growth of lending to households was rather low, while lending to businesses rose at better rates in 2011. Business

Chart 6.2 Share of banks peer groups in total assets



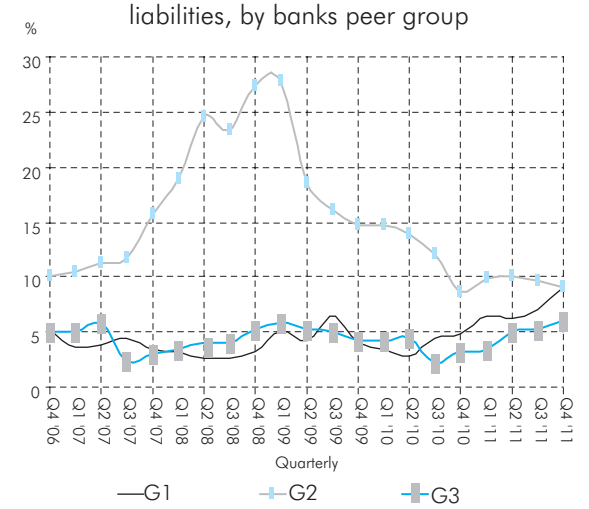
Source: Bank of Albania

Chart 6.3 Banking sector position to non-residents



Source: Bank of Albania

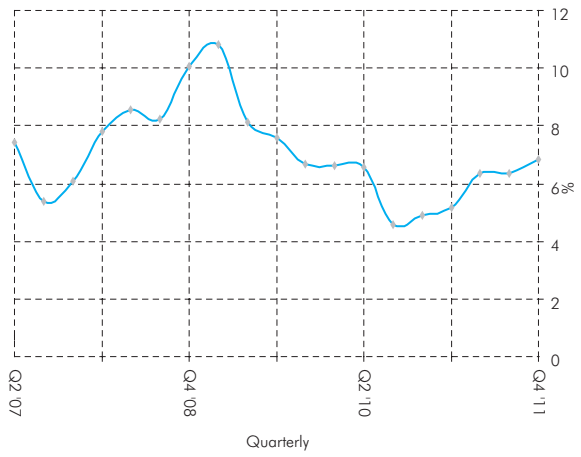
Chart 6.4 Liabilities to non-residents to total liabilities, by banks peer group



Source: Bank of Albania

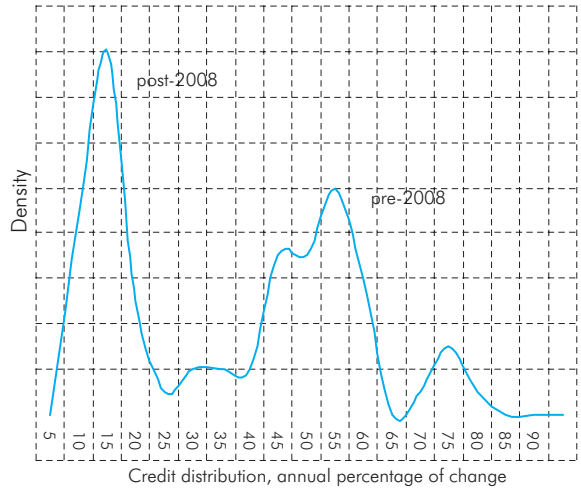
[34] *Registered as an off-balance sheet item.*

Chart 6.5 Liabilities to non-residents to total foreign currency liabilities



Source: Bank of Albania

Chart 6.6 Distribution of credit growth rate



Source: Bank of Albania

loan demand was more oriented towards working capital financing, whereas household loan demand was oriented towards financing of non-durable consumer goods and real estate investments. Agriculture and electricity production recorded the highest annual credit growth, while construction displayed a procyclical behaviour, being further contracted. Banks' expectations for the future indicate a lower loan demand, mainly in terms of financing businesses and real estate sectors[35]. The increase in non-performing loan portfolio and uncertainties about the economic outlook contributed to strengthening the banks' prudence in terms of lending.

As at 2011 H2, outstanding loans increased to ALL 566.2 billion, up by ALL 42.7 billion (8.2%) compared to 2011 H1 and ALL 75.3 billion (15.3%) compared to 2010 H2. Banking sector loan portfolio accounted for about 42.8% of GDP. The distribution of the credit growth rate shows lower growth rates (on average 22%) as from 2008 relative to the previous period.

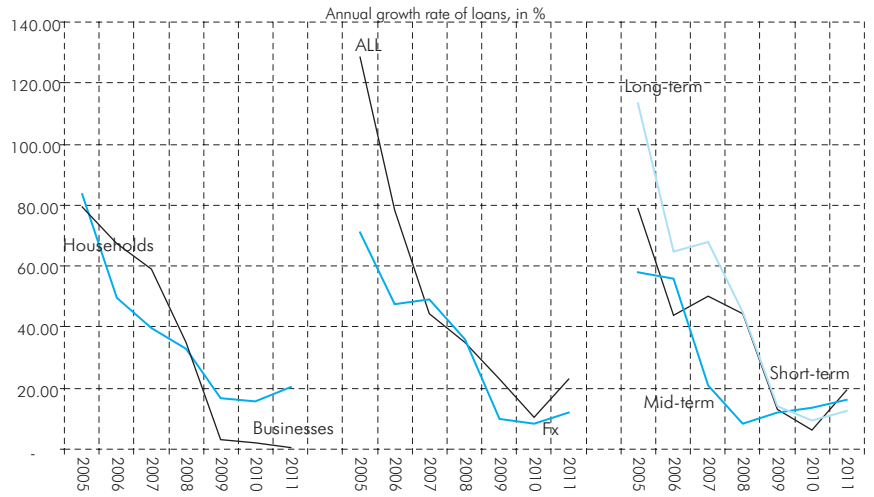
As at end-2011, lending to businesses increased by 20.3%[36], y-o-y, to ALL 397 billion, while lending to households increased by 0.76%, to about ALL 148.8 billion, reaching historically low levels. Foreign currency denominated loans continued to provide the main contribution to credit outstanding growth, though lek-denominated loan growth (up 22.8%, y-o-y) was higher than foreign currency one (up 12.1%, y-o-y). Under the conditions of businesses' needs for liquidity, short-term loans increased by 19.1%, y-o-y, exceeding the 6.3% level recorded in the previous year.

With respect to credit distribution by purpose of use, over a period of 5 years, loans to businesses in the form of overdrafts and real estate investments have had the largest share, while the share of loans for equipment purchase investments has decreased. As regards the distribution of household loans by purpose of use, its share displays a shift towards loans for non-durable consumer goods and real estate investments.

[35] *Based on a survey conducted by the Research Department "Analysis of the Albanian banking sector activity and expectations", February 2012.*

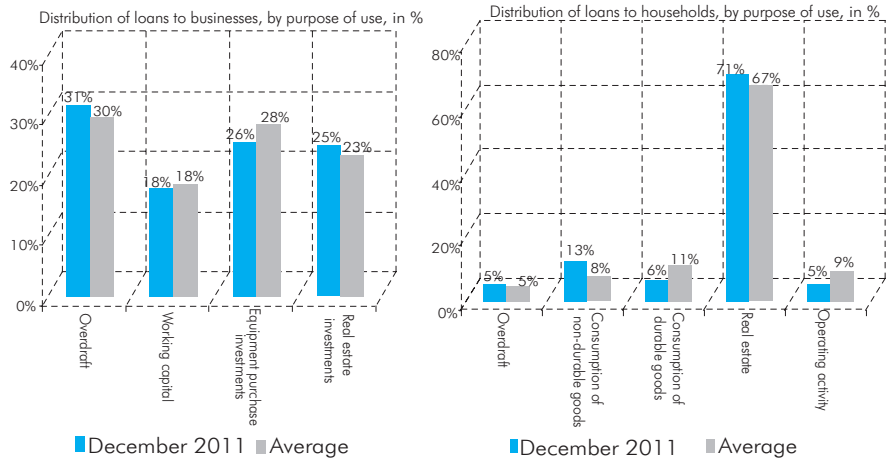
[36] *Credit performance estimates include residents (total loans to residents share about 94.3%) and non-residents (sharing 5.7%) in Albania.*

Chart 6.7 Annual growth rate of loans



Source: Bank of Albania

Chart 6.8 Distribution of loans to businesses and households, by purpose of use

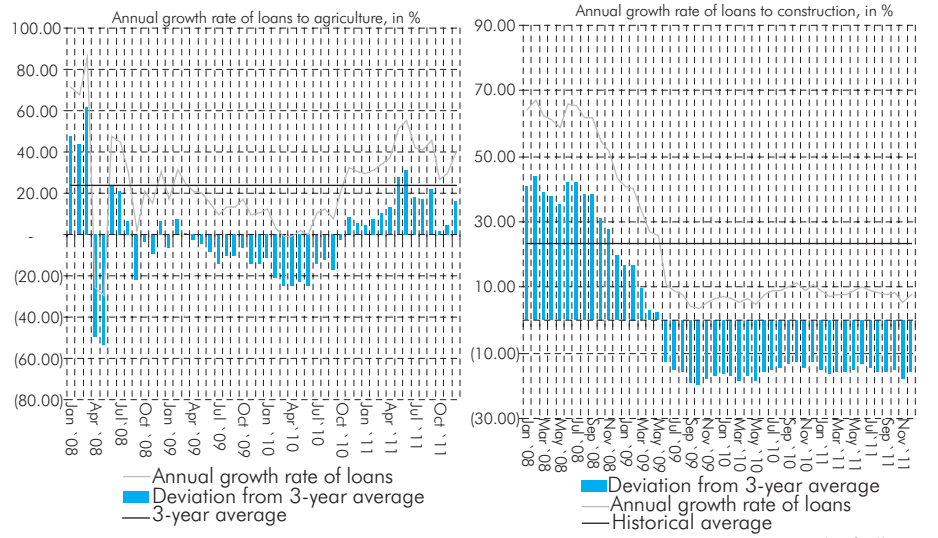


Source: Bank of Albania

The banking sector has supported the electricity production, agriculture and industry more financially. Loans extended to these three sectors have increased by 57.3%, 40.3% and 19.5% y-o-y, respectively. Over the course of three years, agriculture, even though having a relatively low share, has mitigated the slowdown of lending to the economy as a result of faster credit growth rate, exceeding the three-year average (24.1%) by 16.2 percentage points (Chart 6.9).

In recent years, construction has remained the least preferred sector for bank lending because of its weak performance. The annual growth of lending to this sector has continued its downtrend, contracting by about 7.7% in December 2011. Lending to construction has displayed a procyclical behaviour over a three-year time span, during which lending to this sector decreased faster than to the other sectors of the economy (Chart 6.9).

Chart 6.9 Annual growth rate of loans to agriculture and construction

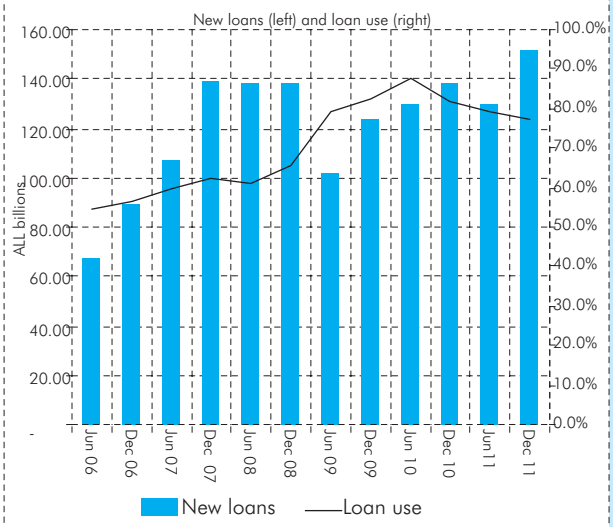


Source: Bank of Albania

BOX 6 NEW LOANS

In 2011 H2, the banking sector new loans amounted to ALL 151.5 billion, up by about ALL 13.7 billion, or 9.9% from 2010 H2. Over the same period, the banking sector collected about ALL 116.6 billion loans, from about ALL 112.7 billion in 2010 H2. The ratio of collected loans to extended loans, which represents the loan use indicator, was 77% in 2011 H2, from 81.8% in 2010 H2, due to a higher growth rate of new loans than of collected loans.

Chart 6.10 New loans and loan use



Source: Bank of Albania

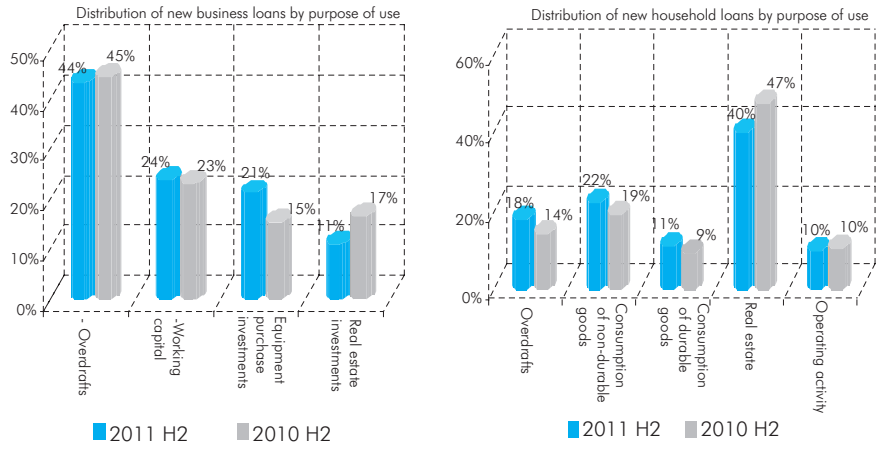
In terms of users, in 2011 H2, businesses were extended about ALL 128.5 billion, or 85% of new loans, while households were extended ALL 23 billion, or about 15% of total new loans. Chart 6.10 shows the performance of new loans and the loan use indicator on a semi-annual basis.

The distribution of new business loans by purpose of use reveals that in 2011 H2, new loans shifted towards investments in equipment purchase. Household sector highlights a higher growth rate in overdrafts, while new loans for real estate purposes have increased more slowly.

In terms of currency, in 2011 H2, new lek and US dollar-denominated loans increased by 15.4% and 116.6%, to ALL 58.4 billion and ALL 15.5 billion, respectively. At the same time, new euro-denominated loans fell by 3% to ALL 77.6 billion.

The analysis of new loan distribution by sectors of the economy highlights three main developments: First, the share of new loans to trade, repair of vehicles and household appliances increased to about 35.9%, from 31% as at end-2010. Second, the share of new loans to processing industry declined to 9.9%, from 13.2% a year earlier. Third, construction remains the least credited sector by the banking sector.

Chart 6.11 Distribution of new business and household loans by purpose of use



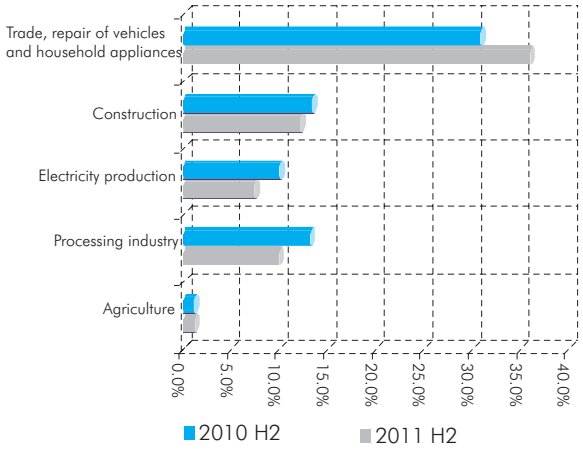
Source: Bank of Albania

- *Interest Rates on New Loans*

The second half of 2011 highlighted an easing trend in banks' lek-denominated loan prices. Interest rates on lek-denominated loans reflected minimum volatility, approaching low levels marked over this period. At the same time, the average interest rate on euro and US dollar-denominated loans has increased.

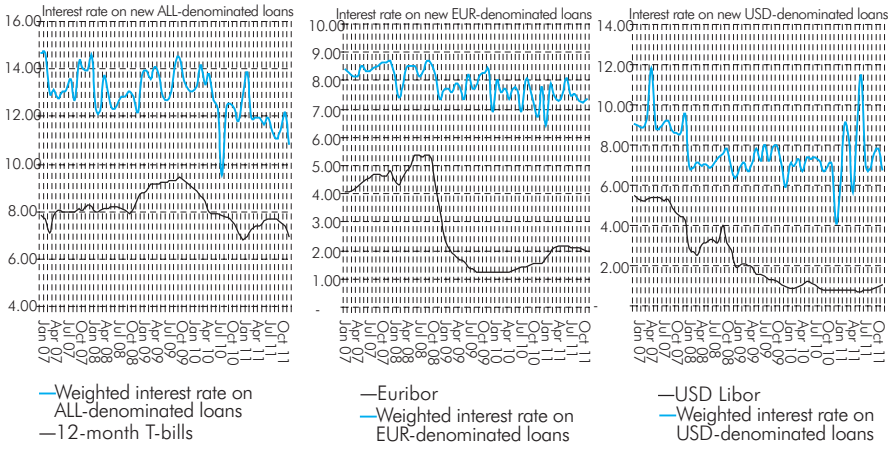
In 2011 H2, the average interest rate on lek-denominated loans fell by 0.9 percentage points relative to 2011 H1, to 11.5%. The business sector benefited from easing terms on overdrafts, since the average interest rate for this category fell by about 2.3 percentage points, to 10.4%. The average interest rate on euro-denominated loans over the same period increased, averaging 7.5%, from 7.4% in 2011 H1. This trend was driven by higher reference rates and higher prices of euro-denominated business loans for equipment purchase investments.

Chart 6.12 Distribution of new loans by sectors of the economy



Source: Bank of Albania

Chart 6.13 Interest rates on new lek and foreign currency-denominated loans



Source: Bank of Albania

The interest rate on the latter increased by 0.29 percentage points, to 7.4%. Banks continue to apply relatively high interest rates on both lek and euro-denominated loans of above 5-year maturity (referring mainly to real estate loans) to household sector. The average interest rates on new US dollar-denominated loans displayed the same uptrend.

6.4 DEPOSITS

The level and performance of the banking sector deposits improved in 2011 H2. Deposits remained concentrated in the largest banks of the banking system and the degree of their concentration increased relative to June 2011. In 2011 H2, total deposits increased by 7.8% compared to June 2010 and 13.1% compared to the previous year.

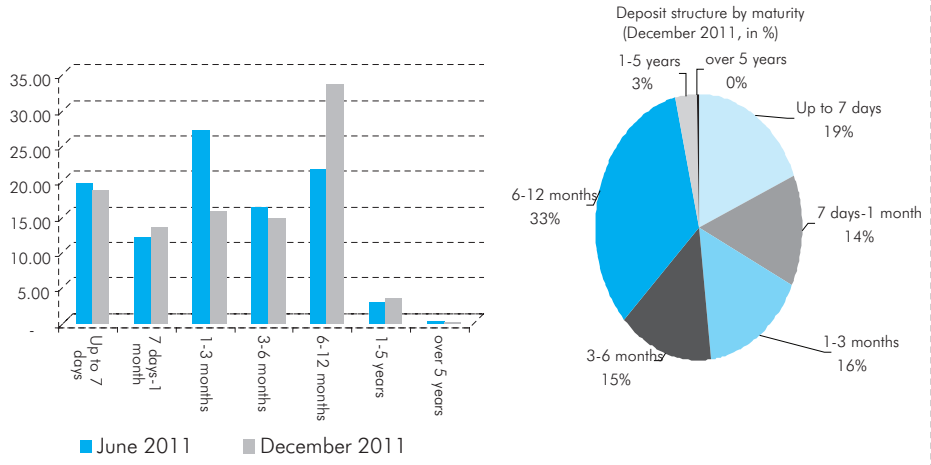
Table 6.3 Deposit growth rate

Period	2004	2005	2006	2007	2008	2009	2010	2011 H1	2011 H2
Deposit growth (in %)	13.4	16.4	20.1	19.9	2.4	7.6	17.7	4.9	7.8

Source: Bank of Albania

Deposit structure highlights a shift of deposits of 1-3 month maturity (down by 38%) towards deposits of 6-12 months and 1-5 years (up by 68% and 23%, respectively) relative to 2011 H1. This performance has reflected the stable public confidence in the banking sector and the ongoing propensity to save versus the propensity to consume. Information obtained from market operators also attests to inflow of savings from Albanian emmigrants working abroad, mainly from Greece.

Chart 6.14 Banking sector deposit structure by maturity



Source: Bank of Albania

Deposit structure by currency highlights that in December 2011, lek-denominated deposits accounted for 50.1% of total deposits, to ALL 462.6 billion, whereas foreign currency-denominated deposits accounted for 49.9% of total deposits, to ALL 461.4 billion. The share of lek-denominated deposits fell by 1.9 percentage points relative to June 2011 and 1.1 percentage points relative to end-2010.

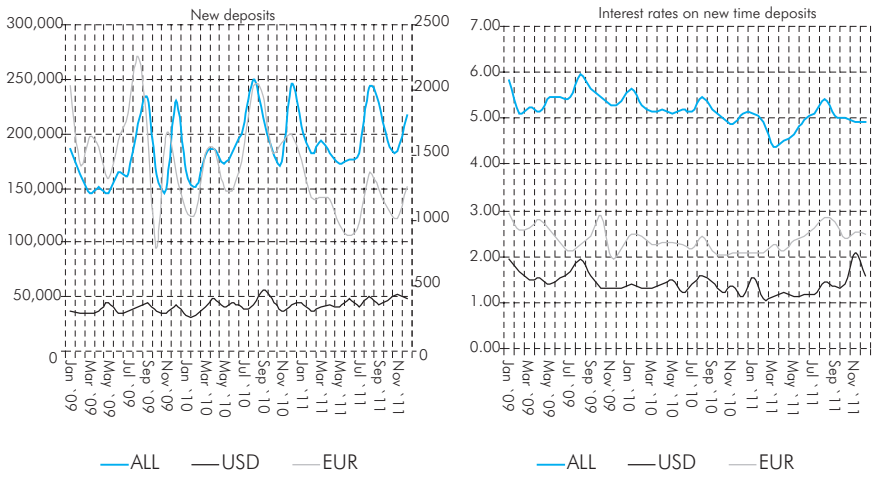
BOX 7 NEW DEPOSITS

New lek time deposits performed worse in 2011 H2. During this period, new lek time deposits accepted by the banking sector totalled ALL 333 billion, or 9.8% less than in 2010 H2. This decline occurred at a time when interest rates on lek deposits fell marginally, to 5.1% from 5.16%. Regarding the maturity structure of new lek deposits, the share of new 1-month deposits marked an annual decline in 2011 H2, by about 5.6 percentage points, to 36.3%, whilst the share of new 1-year deposits increased by about 7 percentage points, to 32%.

New US dollar time deposits accepted by the banking sector in 2011 H2 totalled USD 487.1 million, down by 24.3% from the previous year. Time-deposit structure has changed, mainly in those with a maturity of 1 year, which increased by 4.8 percentage points, and in those with a maturity of 1 month, which decreased by 8.9 percentage points. The average monthly interest rate on new US dollar deposits was 1.5% in 2011 H2, from 1.36% in the same period a year earlier.

New euro time deposits accepted by the banking sector totalled EUR 2.1 billion, down by 50.7% from 2010 H2. This decline occurred, irrespective of the increase by about 0.5 percentage points of the average interest rate on euro time deposits relative to the previous year. Their maturity structure highlights that the share of 1-month euro deposits fell by 33.5 percentage points, to 34.4%, whereas the share of 3 and 12-month euro deposits increased by 11 and 17.8 percentage points in annual terms, to 22.2% and 29.9%.

Chart 6.15 New deposits and interest rates



Source: Bank of Albania

6.5 CAPITAL

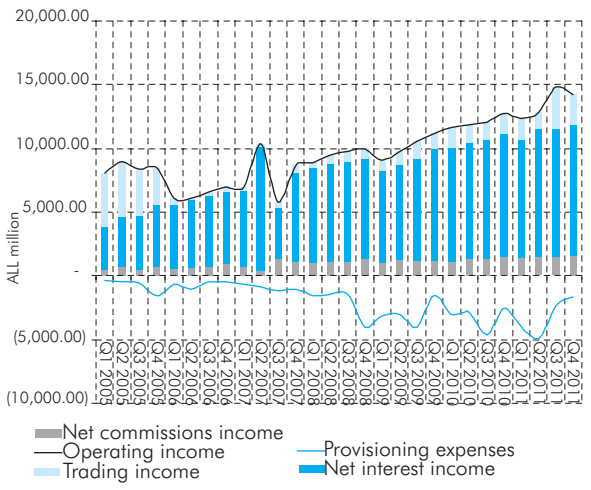
As at 2011 H2, Permanent Resources totalled ALL 113.4 billion, continuing their uptrend. Shareholders' equity - their main item, amounted to ALL 97.3 billion at period-end, up by ALL 7.1 billion, or 7.9% from June 2011 and 4.5% from the previous year. Shareholders' equity accounted for 8.7% of total assets, from 8.6% as at end-June 2011 and 9.4% on a year earlier. Banks peer group 3 accounted for 71.8% of total shareholders' equity of the banking sector, from 69.6% as at June 2011. Paid-in capital totalled ALL

82.8 billion, up by ALL 9.7 billion, or 13.3% from June 2011. It accounted for 7.4% of total assets, up 0.4 percentage points from June 2011 and 0.25 percentage points from end-2010.

6.6 PROFITABILITY AND EFFICIENCY IN USING RESOURCES

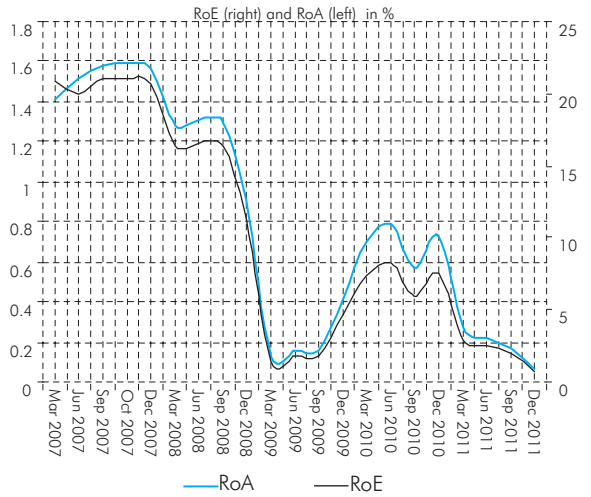
As at 2011 H2, average earning assets rose to ALL 943 billion, accounting for about 89.7% of the banking sector's total average assets. This indicator increased by ALL 23.8 billion or 2.6% from June 2011, and by ALL 87.6 billion or 10.2% from the previous year. Average paying liabilities to average earning assets stood at 94.4%, up by 1 percentage point from June 2011 and 1.4 percentage points from the previous year.

Chart 6.16 Selected operating income components



Source: Bank of Albania

Chart 6.17 Return on Assets (RoA) and Return on Equity (RoE) for the banking sector



Source: Bank of Albania

Banking sector's net operating income[37] is estimated at ALL 39.6 billion, or down by 10.3% from the same period of the previous year, being totally represented by net interest income. Operating costs[38] totalled ALL 24.5 billion, or up by 4.3% from the previous year. As a result, the ratio of operating costs to net income stood at 61.8%, from 53.1% in the same period a year earlier.

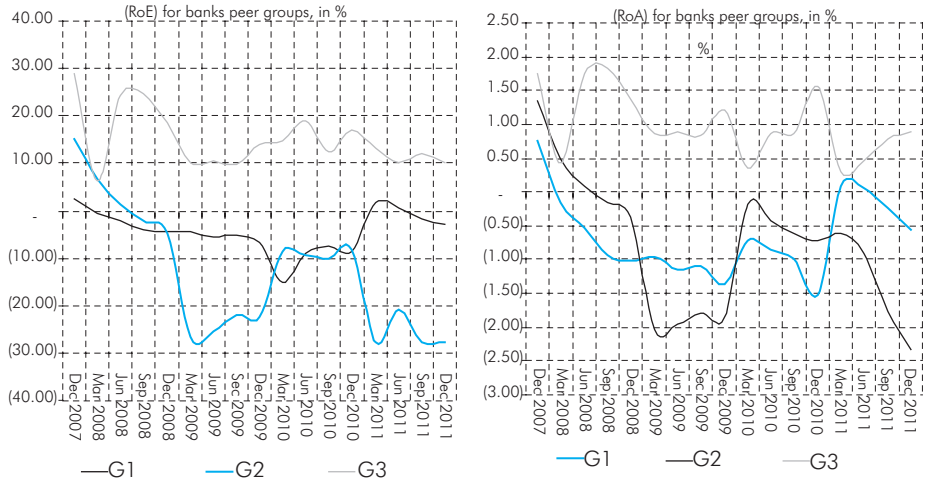
General operating expenses[39] to income reached 94.1%, versus 82.7% in December 2010, as a result of the lower net operating income compared to the same period a year earlier and higher provisioning.

In 2011 H2, net profit was positive, posting ALL 706 million, down by 89.5% from 2010 H2. Despite the increased net interest income by ALL 2.65 billion relative to the same period a year earlier, the lower net profit from other activities (by ALL 7.2 billion, or almost 100%) and higher provisioning expenses to ALL 20.6 billion, or up by ALL 6.8 billion on a year earlier, explain the significant decline in net profit.

Annualized return on assets (RoA) resulted 0.07%, from 0.72% in the same period a year earlier. Annualised return on equity (RoE) resulted 0.76%, from 7.6% as at end-2010.

[37] *Net interest income plus other net income.*
[38] *Excluding provisioning expenses.*
[39] *Operational costs plus expenses for provisioning and other reserves.*

Chart 6.18 Return on Assets (RoA) and Return on Equity (RoE) for banks peer groups by capital size



Source: Bank of Albania

6.7 LEGAL AND REGULATORY IMPROVEMENTS

In November 2011, the Assembly of the Republic of Albania passed several amendments to the Law "On Banks in the Republic of Albania", drafted by the Bank of Albania.

Besides providing a clearer definition of e-money activity and respective financial institutions, for a better approximation to the respective European directive, the law amendments included, inter alia:

1) Defining systemic risk as a risk connected to factors that may jeopardise the stability, asset value and/or confidence in the banking industry or system and overall financial system, as well as vesting the Bank of Albania with some powers to prescribe by regulation the manners and rules for preventing and/or managing this risk;

2) Providing the opportunity of a switch of branches of foreign banks operating in Albania to domestic subsidiaries. The law stipulates this particular way of establishment of an Albanian subsidiary/bank from a foreign bank as mandatory, when the Bank of Albania deems it necessary for managing systemic risk. In practice, this process does not bring about any fundamental changes to daily operations of foreign bank branches, since in a long time they have been licensed and supervised in the same way as banks' subsidiaries. However, this change provides a better legal basis for the current supervision practice;

3) Defining a bridge bank, as an instrument used by international supervisory authorities to address and solve difficult problems encountered by banks. This instrument allows the transfer of healthy assets and liabilities of a poorly performing bank to the bridge bank,

while other assets and liabilities are subject to liquidation, if necessary. Hence, the establishment of a bridge bank is a technique available to supervisory authorities. On the one hand, it enables uninterrupted operations and services of a poorly performing bank to its customers, and on the other, it provides the time needed for finding a final market solution, which would minimise the public cost that may be incurred from placing a bank under immediate liquidation. The Law gives the Bank of Albania powers to prescribe by regulation the grounds for its establishment and regulate the manner of its organisation and functioning, taking into consideration the temporary nature of its functions.

Amendments to the Law "On Banks in the Republic of Albania" also include some alterations and corrections reflecting the so-far experience in implementing it.

VII. MONITORING BANKING SECTOR RISKS

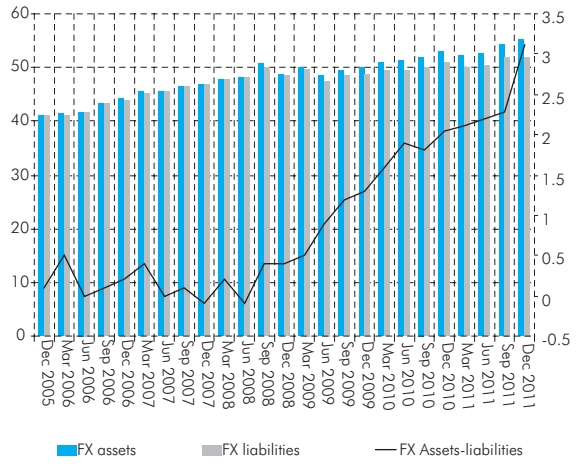
7.1 MARKET RISKS

7.1.1 EXCHANGE RATE RISK

As at end-2011, the banking sector's foreign currency-denominated assets totalled ALL 616.4 billion, or up by 12.5% from 2011 H1 and 17.3% from the previous year. Foreign currency-denominated liabilities totalled ALL 581.4 billion, up by 10.7% from June 2011 and 15.1% from the previous year. At end-2011, the share of foreign currency-denominated assets and liabilities to total assets was 55% and 51.9%, up by 2 percentage points and 0.9 percentage points, respectively, from the previous year. Though the gap between foreign currency-denominated assets and liabilities has increased, it remains within the 0-10% historical band.

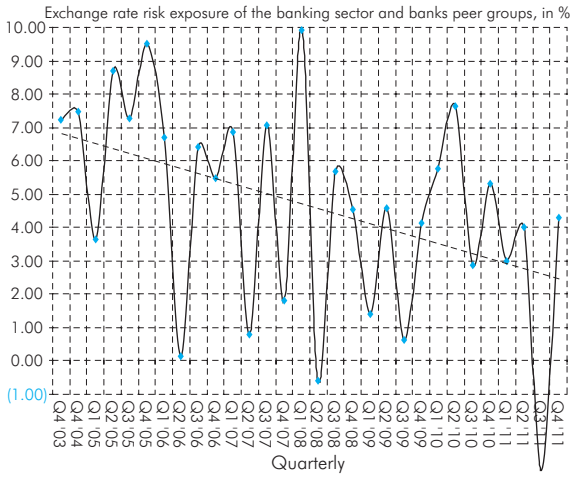
Open position size is assessed as limited and hence the exchange rate risk is moderate. In terms of banks peer groups, G1 and G2 banks generally shifted towards a short position, while G3 banks deepened their long position over the last months of the year.

Chart 7.1 Share of foreign currency-denominated assets and liabilities to total banking sector assets, in percentage (December 2005-December 2011)



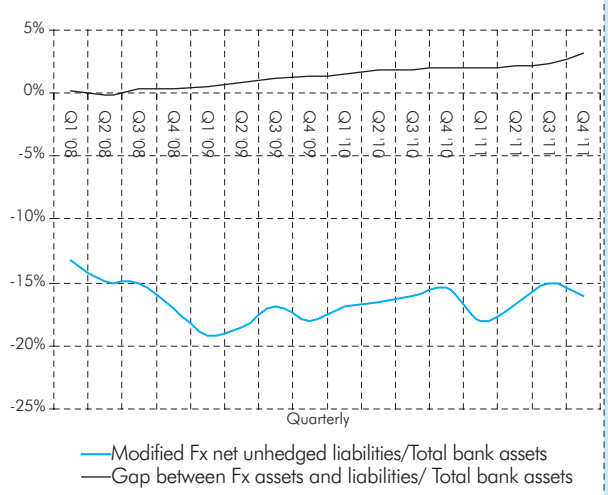
Source: Bank of Albania

Chart 7.2 Exchange rate risk exposure of the banking sector and banks peer groups



Source: Bank of Albania

Chart 7.3 Modified Currency Mismatch Index



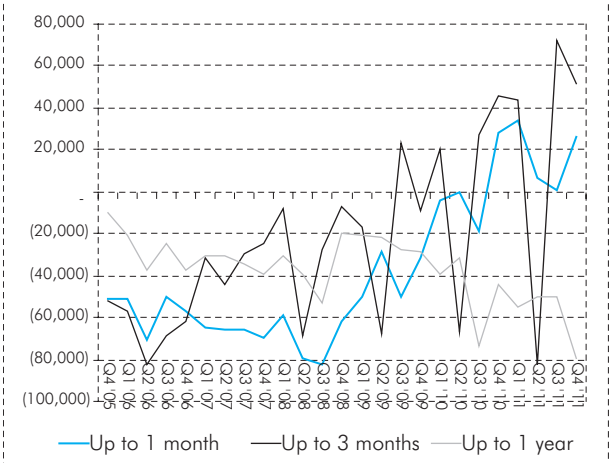
Source: Bank of Albania, Financial Stability Department calculations

BOX 8 MODIFIED CURRENCY MISMATCH INDEX

Modified Currency Mismatch Index presents the performance of banks' exposure to direct and indirect exchange rate risk. During 2011 H2, the index improved to -16.1%, from -16.7% in June 2010. This index is down by 0.7 percentage points from the same period a year earlier. Total foreign currency-denominated assets with non-residents, which in 2011 H2 increased significantly by about 43.1% from 2011 H1, and the decline in collateral-free household loans by -6.4% are the main indicators that have led to this improvement. Irrespective of these changes, the Currency Mismatch Index remains within the -10% to -20% band, with an acceptable volatility.

7.1.2 INTEREST RATE RISK

Chart 7.4 Gap between assets and liabilities according to repricing periods (ALL millions)



Source: Bank of Albania

As at the end of 2011 H2, interest-sensitive assets and liabilities remained at similar levels. The gap between them for up to 1-month and up to 3-month maturity is positive, at ALL 26.3 billion and 51.2 billion, respectively, whilst the gap between assets and liabilities of up to 12-month maturity is negative, at ALL 79.2 billion. The positive gap between short-term assets and liabilities of up to 1 month and 3 months shows that the banking sector is exposed to risk from interest rate cut. Developments in assets and liabilities of up to 12-month maturity reflect exposure to risk from interest rate rise. However, exposure to interest rate risk at sectoral level is moderate relative to total banking sector assets, which in December 2011 was -7.1%. Moreover, the profitability of some banks, which have high levels of this ratio, is vulnerable to interest rate risk.

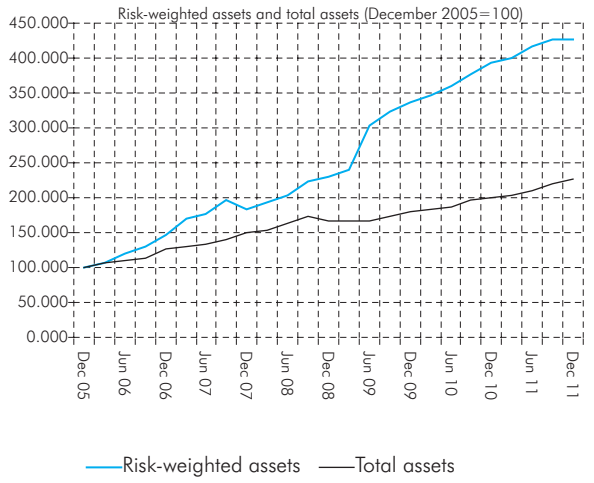
7.2 CREDIT RISK

Uncertainty about the global economic outlook and its impact on Albania's economic developments are associated with economic agents' reluctance to make investments and consume and banks' more cautious policies in terms of lending. As a result, developments on the demand and supply-side have further increased the value of non-performing loans in the banking sector. In parallel with these developments, a larger exposure to indirect credit risk from foreign exchange rate is evidenced, on a year earlier.

In order to assess the level of credit risk posed to banking activity, we first analyse the performance of risk-weighted assets to total assets [40]. As at the end of 2011 H2, risk-weighted assets[41] of the banking sector resulted about ALL 632.7 billion, i.e., about ALL 14 billion, or up by 2.3% from 2011 H1 and ALL 46.7 billion, or up by 7.9% from the same period a year earlier. They account for about 56.5% of total assets of the banking sector. Risk-free assets (0% risk) amounted to ALL 450.3 billion, up by ALL 40.6 billion, or 9.9%, y-o-y. The uptrend of credit risk indicators has made banks carry out fewer investments in high-risk assets. Specifically, in 2011 H2, assets risk-weighted at 150% fell by about ALL 45 billion, or 22.8% compared with the previous six months, down to ALL 152.2 billion. This was due to the shift toward assets risk-weighted at 20% and 100%, which increased by about 36.5% and 29.2%, respectively, relative to 2011 H1. One of the reasons for shifting towards assets risk-weighted at 20% is the implementation of a new regulation on liquidity, which also defines the maintenance of minimum ratios of liquid assets/ short-term liabilities in foreign currency for banks in the country.

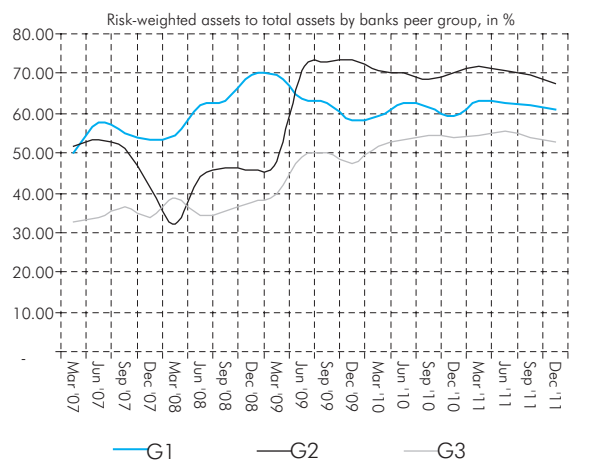
In terms of banks peer groups by size of activity, the ratio of risk-weighted assets to total assets declined for all banks peer groups, as a result of a higher growth rate of assets. G2 banks continue to have the largest share of risk-weighted assets, accounting for about 67.5%.

Chart 7.5 Risk-weighted assets



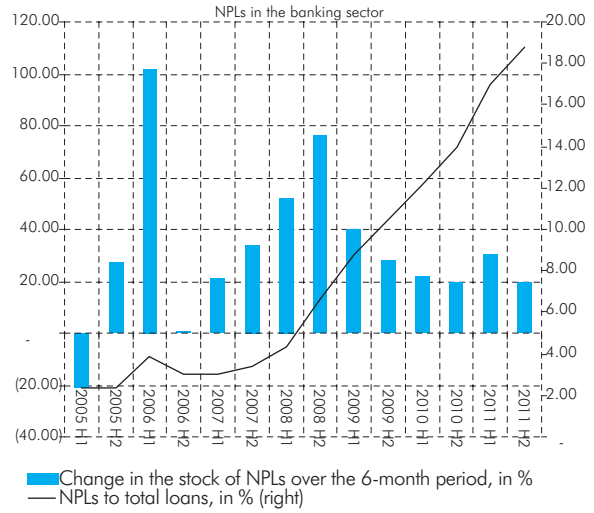
Source: Bank of Albania

Chart 7.6 Risk-weighted assets by banks peer group



Source: Bank of Albania

Chart 7.7 Non-performing loans



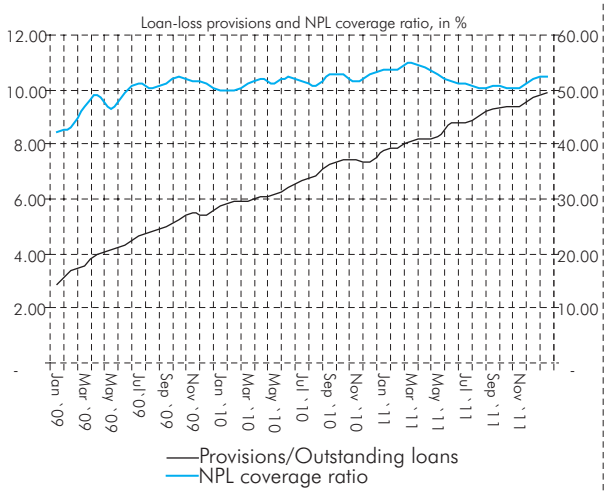
Source: Bank of Albania

[40] *Total assets and total risk-weighted assets have been presented in the form of a ratio to a base period (in our case, December 2005=100).*

[41] *For the purpose of calculating the CAR, they are weighted by a specific risk coefficient (20%, 50%, 100%, or 150%). In general, risk-weighted assets are dominated by the loan portfolio and also include investments in debt securities and placements with financial institutions.*

Non-performing loans in the banking sector continued the uptrend in 2011 H2, amounting to ALL 106.3 billion, from ALL 88.9 billion in 2011 H1 and ALL 68.5 billion in the same period a year earlier. The ratio of non-performing loans to total loans reached 18.8%, from 17% in 2011 H1 and 13.9% in the same period a year earlier.

Chart 7.8 Loan-loss provisions (left) and NPL coverage ratio (right)



Source: Bank of Albania

Total provisions continued the same uptrend as non-performing loans, accounting for about 9.7% of total loans. Over the course of 1 year, the lower increase in provisions (about 52.4%) than in non-performing loans (55%) was reflected in a non-material decline in the coverage ratio, to 51.8%.

The banking sector's capacity to cover losses from non-performing loans with capital diminished as non-performing loans, net, to regulatory capital rose to 52% at end-2011, from 47.4% in 2011 H1 and 35.9% at end-2010. The higher ratio shows that banks should keep more capital to absorb loan losses, in order to maintain their capital adequacy ratios.

Banks pursued a more cautious approach with respect to loan classification. Distribution by category continued to present a high-but-downward share of standard loans, which accounted for about 72.3% of total loans as at December 2011. The second half of 2011 highlighted a shift of standard and special-mention loans[42] towards substandard loans, whose share rose to 9.2%, from 7.8% as at June 2011 and 6.1% as at December 2010. The shift of loans towards lower-quality classes (doubtful and loss loans) was slower.

The banking sector appears more exposed to credit risk in foreign currency loan portfolio and business loan portfolio. Non-performing loans, gross, to total loans for both categories increased to 19.6% and 20.8%, respectively, from 13.8% and 15.5% in the previous year. At the same time, public sector credit accounted for 3.6% of outstanding loans, from 2.6% as at end-2010.

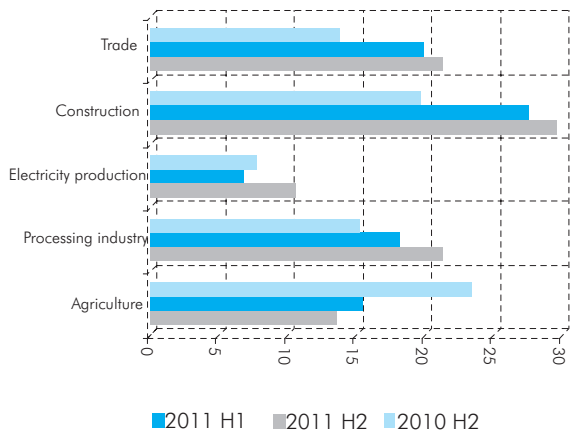
In 2011 H2, the banking sector appeared less exposed to risk from lending to agriculture sector, in which the loan quality indicator fell to 13.6%, from 15.4% in 2011 H1 and 23.4% on a year earlier. Non-performing loans in the agriculture sector fell by about 18.6%. However, the improvement in the quality indicator is attributed to the higher increase in outstanding loans to this sector by about 40% compared with the previous year. Loan portfolio quality was impaired mainly in the construction and trade sectors, being accompanied by an increase in non-performing loan ratio, to 29.6% and 21.3%, respectively.

[42] *The share of loans classified as special mention fell by about 2.5 percentage points, down to 7.4% or ALL 41.7 billion in 2011 H2 relative to 2011 H1.*

Foreign currency-denominated outstanding loans (when borrower's income is in lek) is about ALL 214.8 billion, or 37.9% of total outstanding loans and about 55.9% of foreign currency outstanding loans. By currency, about 87% of these loans is in euro and about 13.1% is in U.S. dollar.

As at end-2011 H2, the ratio of non-performing foreign currency loans (when the borrower is unhedged against exchange rate risk) to foreign currency outstanding loans (when the borrower is unhedged against exchange rate risk) resulted about 18.9%, from 17.1% as at 2011 H1 and 12.5% as at 2010 H2[43]. The increase in these indicators exposes the banking sector to indirect credit risk arising from the exchange rate, since its unfavourable volatility would affect the borrower's solvency.

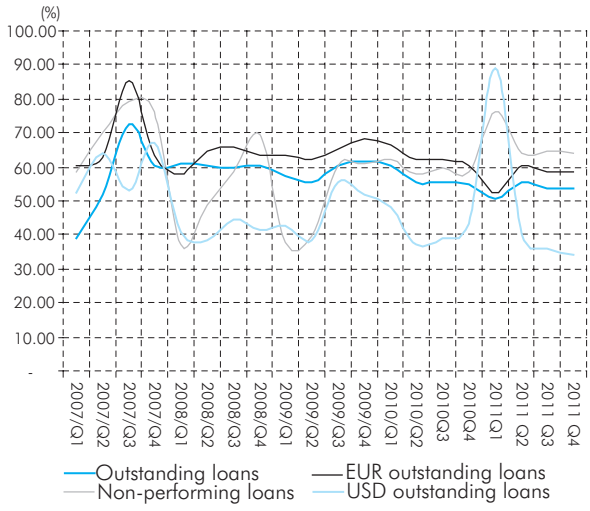
Chart 7.9 Loan portfolio quality by sectors of economy, in percentage



Source: Bank of Albania

As at end-2011, the non-performing loan portfolio coverage ratio[44] declined to 76.4% of the loan portfolio, from 77.6% in 2011 H1 and 79.3% on a year earlier.

Chart 7.10 Real estate secured loans, in %



Source: Bank of Albania

7.3 LIQUIDITY RISK

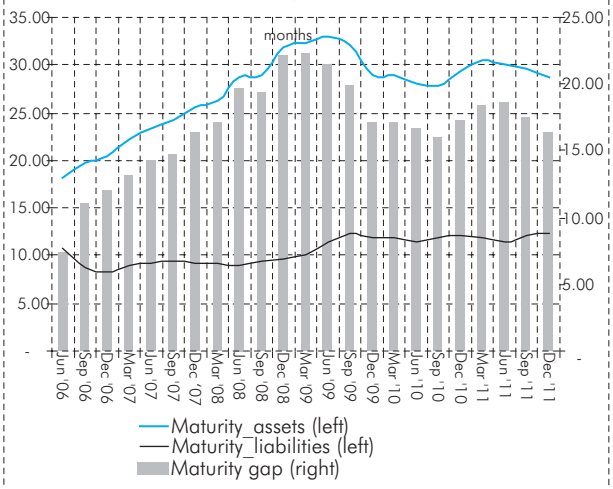
As at 2011 H2, the maturity gap between assets and liabilities narrowed relative to 2011 H1, thus reducing the banking sector exposure to liquidity risk.

As at the end of 2011 H2, the average remaining maturity of banking sector assets is 28.7 months, from 30.1 months in 2011 H1 and 29.5 months on a year earlier. Over the same period, the average remaining maturity of banking sector liabilities is 12.3 months, from 11.5 months in 2011 H1 and 12.1 months as at end-2010. The maturity gap between assets and liabilities narrowed to 16.4 months, from 18.6 months in 2011 H1 and 17.3 months a year earlier (Chart 7.11). The narrowing of asset – liability maturity gap attests to a lower exposure of the banking sector to liquidity risk.

[43] *More specifically, by currency, for the euro this ratio was 20.3% as at December 2011, from 17.6% as at June 2011 and 13.3 as at December 2010. Over the same period, for the U.S. dollar this ratio was 9.9%, from 13% as at June 2011 and 6.5% as at December 2010.*

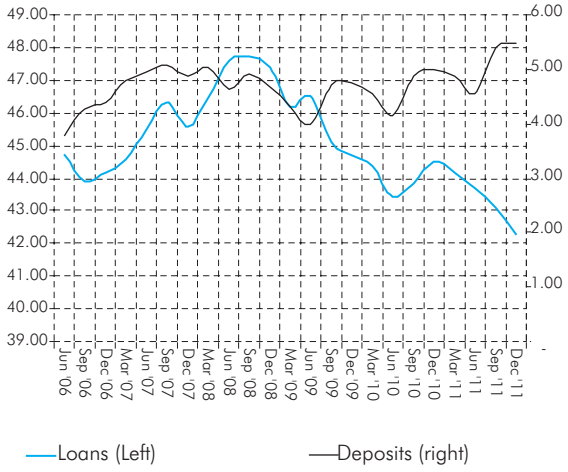
[44] *Collateral in the form of real estate (residential, commercial or land), cash etc.*

Chart 7.11 Average remaining maturity of assets and liabilities, in months



Source: Bank of Albania

Chart 7.12 Average remaining maturity of deposits and loans, in months



Source: Bank of Albania

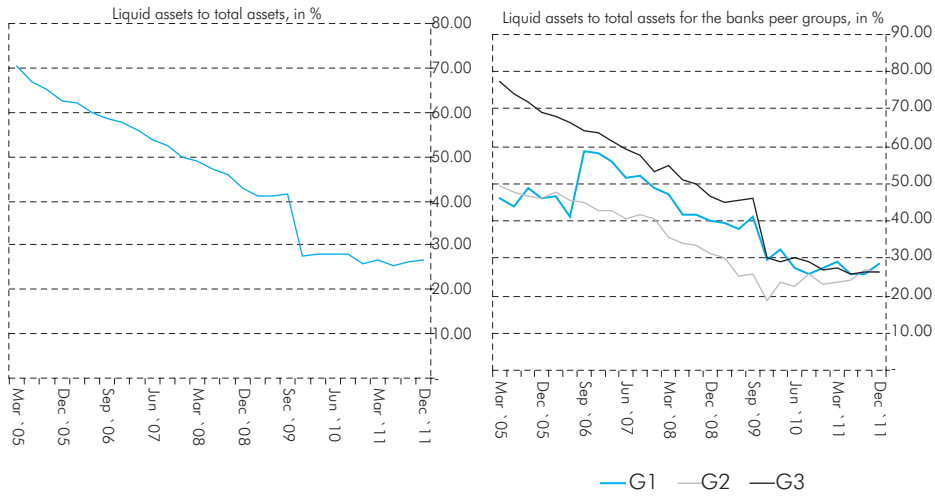
In order to analyse the duration of certain balance sheet items, we focus on developments in loans and deposits, as determinants of the maturity gap in the balance sheet.

In 2011 H2, deposit remaining maturity was 5.5 months, from 4.5 months in 2011 H1 and 4.9 months in the same period a year earlier. Credit remaining maturity was 42.3 months, from 43.7 months in 2011 H1 and 44.5 months in the same period a year earlier (Chart 7.11). The 6-month credit remaining maturity decline by about 1.4 months led to the narrowing of asset - liability maturity gap.

The banking sector's liquidity position appeared stable and improved in 2011 H2. Both main indicators, liquid assets to short-term liabilities and liquid assets to total assets, improved relative to 2010, showing an adequate liquidity level in the banking sector.

As at the end of 2011 H2, the ratio of liquid assets to short-term liabilities (with maturity of up to 1 year) was 33.15%, from 30.2% as at end-June 2011 and 30.6% in the same period a year earlier. By currency, this ratio was higher for the lek (43.1%) and the euro (22.7%) and lower for the U.S. dollar (18.9). The ratio of liquid assets to total assets increased to 26.5%, up by 1 percentage point from the same period a year earlier. By size of activity, the three banks peer groups showed an increase in both indicators, however, banks peer group 1

Chart 7.13 Liquid assets to total assets, in %



Source: Bank of Albania

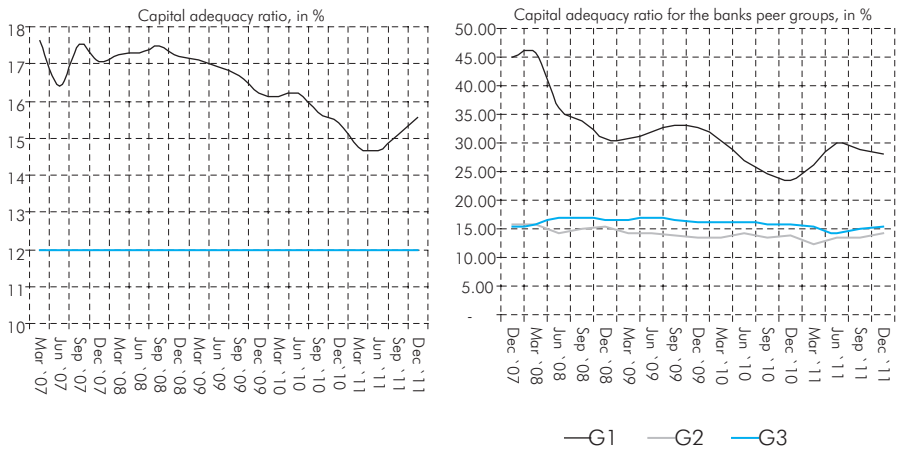
and 2 display substantial changes, particularly in the ratio of liquid assets to short-term liabilities, which increased by 3.7 and 3.5 percentage points, respectively, compared to June 2011.

7.4 BUSINESS CAPITALISATION

As at end-December 2011, regulatory capital rose to ALL 98.5 billion, up by 8.7% and 9.2%, respectively, from June 2011 and a year earlier. Core Tier 1 capital rose to ALL 90.5 billion, up by about ALL 6.7 billion, or 8% from June 2011, and up by ALL 5.4 billion, or 6.3% from the same period a year earlier. Core Tier 1 capital accounted for 91.9% of the regulatory capital, reflecting the stability of the banking sector capital and its adequate quality. As at end-2011, capital adequacy ratio, which measures the "coverage" by capital of the banking sector's risky activities, resulted 15.6%. This indicator increased by 0.9 percentage points compared to June 2011 and 0.2 percentage points on a year earlier. The minimum level of this ratio, defined under the regulatory framework, is 12%. Relative to 2011 H1, it improved significantly, mainly because of the increased capital by some banks.

By banks peer groups, G2 banks have the lowest CAR by 14.1%, though slightly upward compared to 2011 H1. Bank capitalisation level remained good; however, the needs of individual banks to increase their capital call for ongoing monitoring because of the unstable asset quality and slow activity growth rates.

Chart 7.14 Capital adequacy ratio for the banking sector and banks peer groups, in %



Source: Bank of Albania

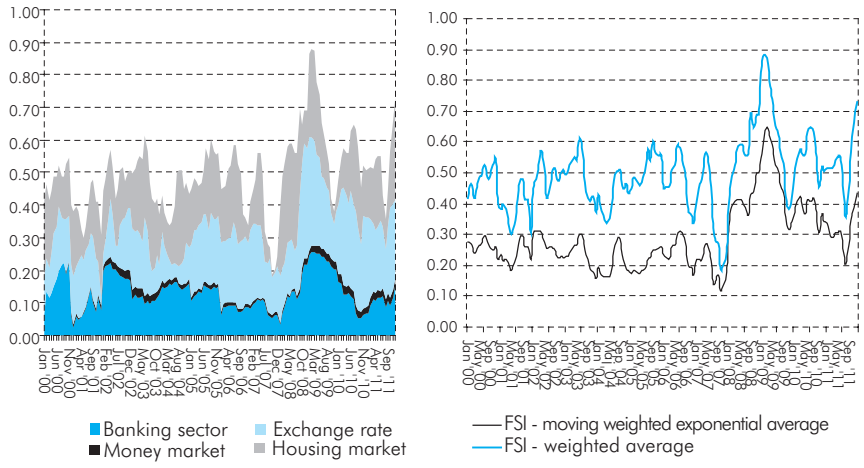
BOX 9 FINANCIAL STRESS INDEX FOR ALBANIA

The recent financial crisis has led to the necessity for an effective measurement of systemic risk, whose assessment remains a key factor in macro-prudential and regulatory policies. Therefore, a measure of systemic risk[i] can help identify and assess threats to financial stability.

This box presents a new index[ii], which aims at measuring the level of financial stress in Albania. It contains data on the level of stress arising from different components of the financial system, aggregated into a single Financial Stress Index (FSI). Indicators grouped into 4 sub-indices represent the principal components of the financial system: banking sector, money market, exchange rate and housing market. Fluctuations, deviations of indicators from their long-term trend and the spread between reference interest rates in the money market are used to identify the features of systemic stress for each component. The indicators considered for constructing the sub-indices are standardised and later calibrated by comparison with the 0-1 band.

Each sub-index is computed by analysing the principal component approach, aiming to aggregate the data provided by different market variables into a single index. Later, the four sub-indices are aggregated through the standard portfolio theory, under which the total portfolio risk increases when correlated risk-bearing assets are aggregated into a single portfolio, vis-à-vis the case when these assets are not correlated. Thus, the high correlation among different assets denotes increased systemic risk. Finally, the main component in constructing the Financial Stress Index (FSI) is the weighting method of sub-indices, which reflects the relative importance of each component in the aggregate index. The aggregation of these weights for our economy produced the following figures: 26.8% for the banking sector, 3.1% for the money market, 36% for the exchange rate market and 34% for the housing market.

Chart 7.15 Financial Stress Index



Source: Financial Stability Department calculations

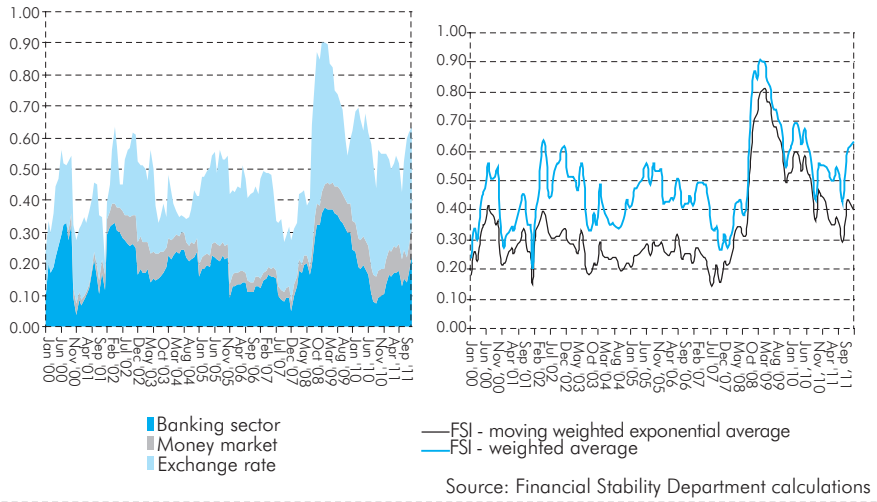
Chart 7.14 shows the developments in the Financial Stress Index and the contributions of each sub-component to overall systemic stress. This index highlights two main periods of a higher stress level: early 2002 - a period which corresponds to deposit withdrawals, and late 2008 - the recent financial crisis. In terms of market component contribution, the banking sector makes the highest contribution in periods of financial

stress. However, during the recent crisis, the exchange rate - through the national currency depreciation, particularly against the euro - and the housing market developments have exerted pressure on stress levels. A moderate contribution has been made by fluctuations in the money market, due to its limited development, which is reflected in its share to the index.

The housing market, which is not part of the financial system, is aggregated into this index to assess its direct exposure to other markets in the system. However, in case of not being taken into account, the weights of other sub-indices in the stress index are: 38.2% for the banking sector, 14.5% for the money market and 47.3% for the exchange rate. This approach highlights a higher impact of foreign exchange market developments on the systemic risk and economic activity.

However, both approaches suggest that following the highest systemic risk level recorded in March 2009, exposure to systemic risk decreased gradually until August 2010. Since then, the systemic risk has increased due to the continuous depreciation of the national currency and deterioration of the banking sector balance sheet.

Chart 7.16 Financial Stress Index excluding the housing market sub-index



Source: Financial Stability Department calculations

[i] *Systemic risk is the materialization of shocks, when financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially (Hollo et al, 2011).*

[ii] *A detailed presentation of the Systemic Risk Index is presented in the material "A Financial Stress Index for Albania", by Vasilika Kota and Arisa Saqe, Financial Stability Department, Bank of Albania, Fifth Regional Workshop "Economic Research in South-Eastern Europe", Tirana, 10-11 November 2011.*

7.5 STRESS-TESTING

A forward-looking stress-testing analysis is conducted to assess the financial system stability and the banking sector's capital adequacy over a time-span of up to end-2013. Stress-testing exercise assesses the impact of macroeconomic situations on the banking sector financial condition, excluding the possibility of an increase in paid-in capital during the period under review. In practice, the situation generally worsens gradually and banks have time to take appropriate measures by injecting capital.

This exercise includes three scenarios: the baseline scenario, which is built on the forecast of economic and financial indicators, generally based on their historical performance; and two adverse scenarios, which assume a "stressed" situation of low probability of occurrence, based on two probable shocks to the economy: a) further slowdown in lending, and b) national currency depreciation.

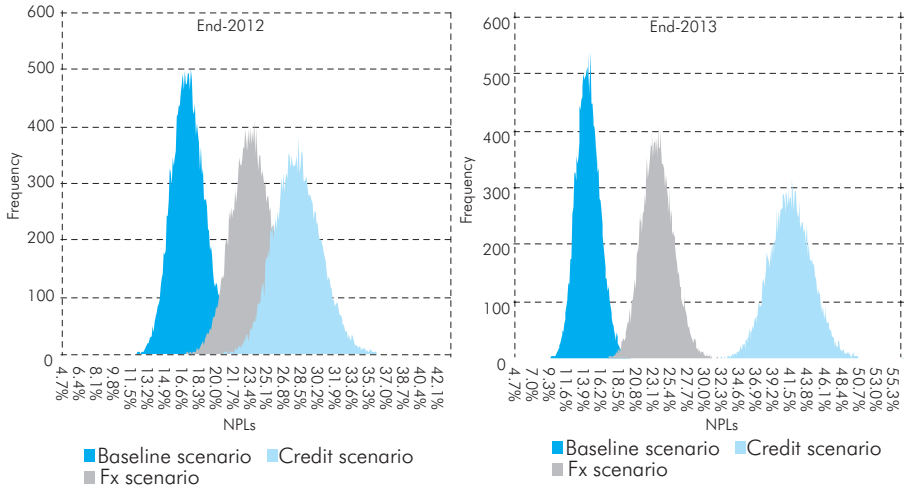
Table 7.1 Stress-testing assumptions

	Baseline scenario		Exchange rate scenario		Credit scenario	
Value in average terms	2012	2013	2012	2013	2012	2013
Annual GDP growth, in %	2.62	3.0	2.57	2.38	1.33	0.86
Annual growth of market interest rates	0.2 pp	0.25 pp	0.35 pp	0.5 pp	0.35 pp	0.5 pp
Lek's depreciation against both major currencies (EUR and USD), in %	-1.6	-1.5	5.1	10.07	-1.6	-1.5
Forecasted growth of outstanding loans, in %	14	12.5	14	12.5	9	5

Source: Research Department calculations, Bank of Albania

Chart 7.17 shows estimates of the loan portfolio quality indicator as at end-2013 according to baseline and adverse scenarios. The distribution of portfolio quality values appears broader for the credit scenario, evidencing a strong impact of the sluggish lending performance on portfolio quality and subsequently on capital adequacy ratio.

Chart 7.17 Distribution of density of NPL values for 2012 Q4 and 2013 using Monte Carlo simulations, according to baseline and adverse scenarios



Source: Financial Stability Department

Table 7.2 shows the banking sector sensitivity to loan quality shocks, estimated in terms of the CAR and the need for additional capital for end-2012 and 2013.

Table 7.2 Stress-testing results in terms of banking sector capitalisation for 2012

Results for end-2012						
	Baseline scenario		Exchange rate scenario		Credit scenario	
	Bank	Sector	Bank	Sector	Bank	Sector
Regulatory capital/Total risk-weighted assets		Capitalized		Capitalized		Capitalized
Modest undercapitalisation /1	Yes		Yes		Yes	
Severe undercapitalisation /2	No		Yes		Yes	
Tier 1 capital/Total risk-weighted assets		Capitalized	Yes	Capitalized	Yes	Capitalized
Modest undercapitalisation /3	Yes		Yes		Yes	
Severe undercapitalisation /4	Yes		Yes		Yes	

/1 = Below the 12% ratio
/2 = Below the 6% ratio
/3 = Below the 6% ratio
/4 = Below the 3% ratio
Source: Financial Stability Department

Table 7.3 Stress-testing results in terms of banking sector capitalisation for 2013

Results for 2013						
	Baseline scenario		Exchange rate scenario		Credit scenario	
	Bank	Sector	Bank	Sector	Bank	Sector
Regulatory capital/Total risk-weighted assets		Capitalized				Capitalized
Modest undercapitalisation /1	Yes		Yes		Yes	
Severe undercapitalisation /2	No		No		Yes	
Tier 1 capital/Total risk-weighted assets		Capitalized				Undercapitalised
Modest undercapitalisation /3	Yes		Yes		No	
Severe undercapitalisation /4	No		Yes		No	

/1 = Below the 12% ratio
/2 = Below the 6% ratio
/3 = Below the 6% ratio
/4 = Below the 3% ratio
Source: Financial Stability Department

The stress-testing exercise reveals that the overall banking sector appears resilient to assumed shocks. The banking sector capitalisation level remains above the minimum required ratio in the event of the baseline scenario. In the event of the adverse scenario, which includes the assumption of credit slowdown and decline in GDP growth rate, the banking sector may need additional capital. Individual banks present seem to need additional capital in the event of both baseline scenario and adverse scenarios. In general, the banking activity is conducted in a challenging internal and external economic environment, therefore, banks should cautiously monitor their activity, in order to identify and meet their needs for capital in due time.

ANNEX

ANNEX 1 FINANCIAL STRENGTH INDEX[45]

The banking sector performance as at 2011 H2, assessed through developments in the Financial Strength Index (FSI), improved relative to 2011 H1, but slowed down relative to the same period a year earlier. These developments were driven by the combined effect of sub-indices forming the FSI.

The assessment of the sub-indices forming the FSI for the banking system as at the end of 2011 H2 is presented below:

Asset Quality Sub-Index[46]: Its downward performance signals a negative impact on the banking sector's position and vice versa. The asset quality sub-index continued to edge down from its historical values, falling to 66.2 at the end of 2011 H2, from 68.6 at the end of 2011 H1 and 74.2 in the same period a year earlier. Its values have decreased markedly from the 85.7 period average. The base ratios forming this sub-index have only increased over the course of six years, which indicates a downward quality of the banking sector assets.

Liquidity Risk Sub-Index: Its downward performance signals a negative impact on the banking sector's position and vice versa. The liquidity sub-index peaked at 89.5 in 2011 H2, from 67.2 in 2011 H1 and 79.8 on a year earlier. The improvement in this sub-index is attributed to the increase in assets of up to 3-month maturity to liabilities of up to 3-month maturity, a ratio that increased by 7.7 percentage points over the course of one year.

Exchange Rate Risk Sub-Index[47]: Its downward performance signals a negative impact on the banking sector's position. The banking sector was less exposed to exchange rate risk, reaching 123.6 in 2011 H2, from 116 in 2011 H1 and 111.1 in 2010 H2. The improvement in this sub-index was mainly driven by the decreased radio of FX open general position (balance sheet items) to regulatory capital[48].

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[45] *The methodology of constructing the Financial Strength Index was introduced in the Financial Stability Report 2010 H1.*

[46] *Indirect proportion has been used to construct this sub-index.*

[47] *Indirect proportions have been used to construct this sub-index due to the negative sign (direction of impact) in the table.*

[48] *In December 2011, this ratio was 3.7%, from 5.7% in June 2011 and 5.9% in December 2010.*

Profitability Sub-Index: Its upward performance signals a positive impact on the banking sector's position and vice versa. As at the end of 2011 H2, this sub-index recorded the lowest historical value since December 2005, to 71.6, from 75.1 as at end-2011 H1 and 85 as at end-2010. This performance was driven by a simultaneous decline in both ratios composing this sub-index, hence affecting the banking sector's position adversely.

Capital Adequacy Sub-Index: Its downward performance signals a negative impact on the banking sector's position and vice versa. The capital adequacy sub-index is equally composed of the free capital/total assets and the CAR. At the end of 2011 H2, this sub-index returned to upward rates compared to the previous six-month period, reaching 63.8, from 62 in 2011 H1, though remaining below its historical average of 86.5.

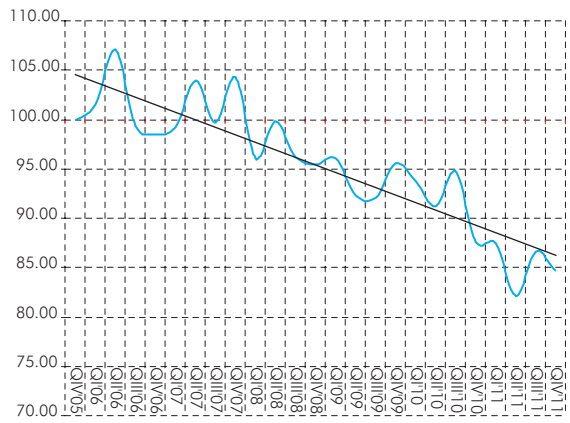
Interest Rate Risk Sub-Index[49]: Its downward performance signals a negative impact on the banking sector's position. At the end of 2011 H2, the performance of interest rate risk sub-index showed higher exposure of the banking system to interest rate movements relative to 2011 H1 and on a year earlier. This exposure was due to upward rates, mainly of the interest rate sensitive asset/liability gap of up to 1 month (in foreign currency) to shareholders' equity ratio, which stood at about 71% as at December 2011, from 57% on a year earlier.

Financial Strength Index (FSI) is calculated by taking the arithmetic average of the above sub-indices. Their combined effect made the banking sector's FSI to increase to 84.7, from about 82.1 in 2011 H1, albeit remaining below the previous year's figure (87.6).

The increase in the FSI by about 3.2 units owes to increase in liquidity and CAR, as well as to a lower exposure to exchange rate fluctuations, while the negative contribution to the banking sector is attributed to the lower asset quality and profitability level, as well as to a higher exposure to interest rate fluctuations.

Charts 8.1, 8.2 and 8.3 show the FSI and its sub-indices for the banking sector.

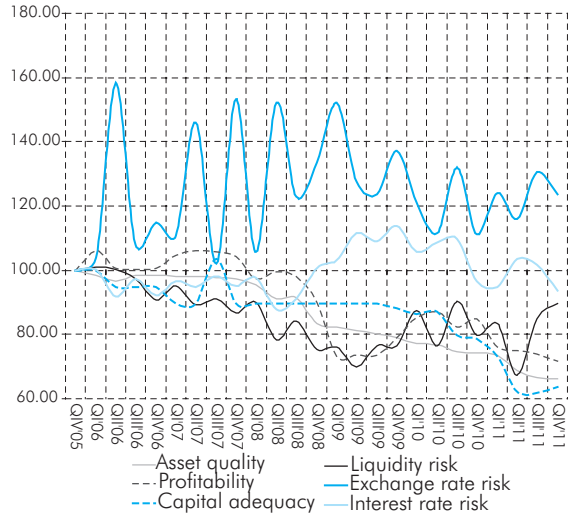
Chart 8.1 Financial Strength Index



Source: Bank of Albania, Financial Stability Department calculations

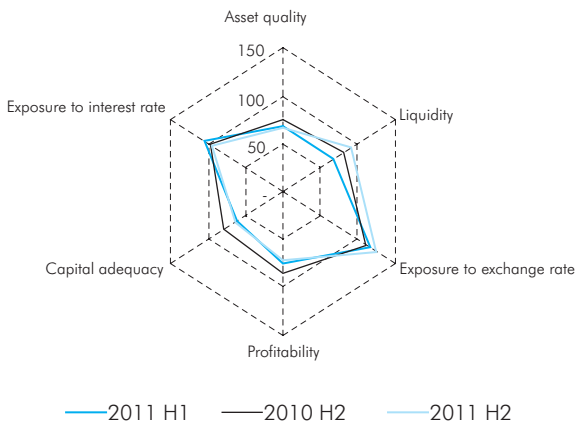
[49] *Interest rate risk is measured through the time mismatching of assets and liabilities, which exposes the banking system to interest rate fluctuations. Indirect proportion is used to measure this sub-index.*

Chart 8.2 Financial Strength Sub-Indices



Source: Bank of Albania, Financial Stability Department calculations

Chart 8.3 Map of the FSI for the banking sector



Source: Bank of Albania, Financial Stability Department calculations

ANNEX 2 FINANCIAL STRENGTH INDICATORS FOR THE BANKING SECTOR

Table 8.1 Financial strength indicators for the banking sector

(%)	Dec '08	Dec '09	Dec '10	Dec '11	Dec '11
CAPITAL-BASED INDICATORS					
Regulatory capital to risk-weighted assets	17.2	16.2	15.4	14.6	15.6
Core capital to risk-weighted assets	16.3	15.3	14.5	13.5	14.3
Core capital to total assets	7.8	8.7	8.6	8.0	8.1
Regulatory capital to total assets	8.3	9.2	9.1	8.7	8.8
Shareholders' equity to total assets	8.6	9.6	9.4	8.6	8.7
NET NON-PERFORMING LOANS TO CAPITAL					
Net non-performing loans to core capital	23.0	29.9	38.1	51.3	56.6
Net non-performing loans to regulatory capital	21.7	28.2	35.9	47.4	52.0
Net non-performing loans to shareholders' capital	21.1	27.1	34.8	47.6	52.6
GROSS NON-PERFORMING LOANS TO TOTAL LOANS	6.64	10.48	13.96	17.00	18.77
RETURN ON EQUITY (RoE) (annual basis)	11.4	4.6	7.6	2.4	0.8
RETURN ON ASSETS (RoA) (annual basis)	0.9	0.4	0.7	0.2	0.1
INDICATORS OF INCOME AND EXPENDITURES					
Interest margin to gross income	106.5	119.6	118.9	146.6	147.7
Non-interest expenditures to gross income	81.4	231.4	227.5	289.7	353.2
LIQUIDITY					
Liquid assets to total assets	42.8	27.6	25.9	25.5	26.5
Liquid assets to short-term liabilities (up to one year)	64.9	32.6	30.6	30.2	33.1
Deposit/Loan ratio	162.6	154.3	166.4	163.7	163.2
NET OPEN FOREIGN CURRENCY POSITION TO CAPITAL					
Net open foreign currency position to core capital	4.5	4.1	5.3	4.0	4.3
Net open foreign currency position to regulatory capital	4.3	3.9	5.0	3.7	3.9
Net open foreign currency position to shareholders' capital	4.0	4.3	5.4	4.1	4.3

Source: Bank of Albania

Table 8.2 Financial strength indicators for banks peer groups

	December '08			December '09			December '10			June '11			December '11		
(%)	G1	G2	G3	G1	G2	G3	G1	G2	G3	G1	G2	G3	G1	G2	G3
CAPITAL-BASED INDICATORS															
Regulatory capital to risk-weighted assets	30.8	15.3	16.6	32.7	13.6	16.1	23.4	13.8	15.6	30.0	13.5	14.3	28.0	14.1	15.5
Core capital to risk-weighted assets	29.1	12.5	16.5	32.7	10.9	15.9	23.4	11.6	15.5	30.0	10.7	13.8	28.0	11.1	14.8
Core capital to total assets	20.3	8.1	7.0	19.1	8.0	8.2	13.9	8.1	8.4	18.7	7.6	7.7	17.0	7.5	7.8
Regulatory capital to total assets	21.5	10.0	7.1	19.1	10.0	8.3	13.9	9.6	8.5	18.7	9.6	7.9	17.0	9.5	8.2
Shareholders' equity to total assets	21.3	7.7	8.2	20.0	8.4	9.3	14.8	8.6	9.3	19.8	8.2	8.3	17.9	7.9	8.5
NET NON-PERFORMING LOANS TO CAPITAL															
Net non-performing loans to core capital	3.62	33.07	23.42	4.9	51.9	27.0	15.1	46.9	37.2	14.4	61.1	52.4	15.8	81.5	53.4
Net non-performing loans to regulatory capital	3.42	26.91	23.24	4.9	41.5	26.7	15.1	39.5	36.8	14.4	48.7	50.6	15.8	64.1	51.2
Net non-performing loans to shareholders' capital	3.45	32.07	20.31	4.7	49.3	23.8	14.2	44.5	33.3	13.6	56.8	48.5	14.9	77.3	49.3
GROSS NON-PERFORMING LOANS TO TOTAL LOANS	3.50	7.67	6.37	4.9	13.1	9.6	9.7	13.6	14.6	11.2	17.4	17.1	11.8	22.5	17.6
RETURN ON EQUITY (RoE) (annual basis)	(4.48)	(4.83)	18.52	(6.54)	(22.48)	14.07	(8.78)	(8.29)	17.00	0.59	(21)	10.24	(3.03)	(27.75)	10.29
RETURN ON ASSETS (RoA) (annual basis)	(1.02)	(0.37)	1.39	(1.36)	(1.85)	1.22	(1.53)	(0.73)	1.55	0.05	(0.90)	0.45	(0.55)	(2.33)	0.89
INDICATORS OF INCOME AND EXPENDITURES															
Interest margin to gross income	79	121	105	90	210	108	103	152	111	74	300	132	88	386	127
Non-interest expenditures to gross income	145	122	67	168	256	232	178	831	62	121	1,997	85	146	2,938	111
LIQUIDITY															
Liquid assets to total assets	40.1	31.1	46.6	29.7	18.4	30.4	27.5	23.2	27.1	25.9	24.1	26.0	28.7	26.6	26.4
Liquid assets to short-term liabilities (up to one year)	63.6	49.5	69.3	38.6	23.2	34.9	34.3	29.1	31.0	36.5	30.9	29.8	40.2	34.3	32.5
Deposit/Loan ratio	149.5	100.77	190.32	147	103.72	178.63	157.3	120	200.71	136.1	116.6	187.96	137.63	124.85	180.82
NET OPEN FOREIGN CURRENCY POSITION TO CAPITAL															
Net open foreign currency position to core capital	2.4	12.8	2.6	(1.32)	7.97	3.77	-1.8	0.1	8.5	(5.91)	(2.02)	8.74	(4.32)	(2.61)	8.84
Net open foreign currency position to regulatory capital	2.3	10.4	2.6	(1.32)	6.38	3.73	-1.8	0.1	8.5	(5.91)	(1.61)	8.45	(4.32)	(2.05)	8.48
Net open foreign currency position to shareholders' capital	2.3	11.8	2.2	(1.26)	9.89	3.80	-1.7	0.1	7.7	(5.57)	(2.91)	8.10	(4.09)	(3.77)	8.16

Source: Bank of Albania

Table 8.3 Financial strength indicators for banks peer groups, by origin of capital

	December '08				December '09				December '10				June '11				December '11			
(%)	Ital.	Fr.	Gr.	Al.	Ital.	Fr.	Gr.	Al.	Ital.	Fr.	Gr.	Al.	Ital.	Fr.	Gr.	Al.	Ital.	Fr.	Gr.	Al.
CAPITAL-BASED INDICATORS																				
Regulatory capital to risk-weighted assets	16.9	15.5	16.5	14.7	18.8	14.2	14.1	14.2	17.6	13.2	14.8	13.6	18.7	13.3	13.3	12.7	20.2	12.5	16.6	13.9
Core capital to risk-weighted assets	16.3	13.2	16.5	10.4	17.9	11.3	14.1	11.2	16.9	12.8	12.0	11.1	18.0	11.3	11.5	10.4	19.4	10.7	14.3	11.0
Core capital to total assets	7.9	8.3	10.8	7.5	8.5	8.6	11.2	7.8	9.4	8.4	10.2	6.8	10.2	8.3	9.0	6.7	9.8	7.6	10.0	7.6
Regulatory capital to total assets	8.2	9.7	10.8	10.6	9.0	10.8	11.2	9.9	9.8	10.3	10.5	8.4	10.6	9.8	10.4	8.2	10.2	8.9	11.6	9.7
Shareholders' equity to total assets	9.3	9.1	9.1	8.3	10.5	9.5	11.6	8.1	10.3	9.3	10.9	7.3	11.1	9.6	8.8	7.1	10.4	8.4	9.9	8.2
NET NON-PERFORMING LOANS TO CAPITAL																				
Net non-performing loans to core capital	12.5	47.6	10.5	16.4	25.0	70.0	22.8	42.4	47.1	50.7	35.5	41.0	53.6	44.0	96.8	32.1	50.2	60.4	115.2	40.4
Net non-performing loans to regulatory capital	12.1	40.7	10.5	11.6	23.8	55.4	22.8	33.4	45.1	41.2	34.3	33.5	51.6	37.1	84.1	26.5	48.3	51.9	99.0	31.9
Net non-performing loans to shareholders' capital	10.7	43.3	17.3	14.8	20.3	63.4	21.9	40.6	42.6	45.9	33.0	38.2	49.3	38.0	98.7	30.4	47.6	55.1	116.0	37.7
GROSS NON-PERFORMING LOANS TO TOTAL LOANS	4.3	12.7	4.5	3.1	8.8	18.6	8.1	8.1	17.8	18.2	12.1	9.1	21.1	17.3	23.5	8.1	22.7	18.4	33.3	9.6
RETURN ON EQUITY (RoE) (annual basis)	11.8	(18.9)	8.2	19.1	15.7	(30.8)	(5.7)	4.5	5.1	(3.2)	(3.8)	5.2	11.9	(7.6)	(38.2)	15.9	2.3	(14.2)	(38.5)	18.7
RETURN ON ASSETS (RoA) (annual basis)	1.0	(1.7)	0.7	1.4	1.5	(2.8)	(0.6)	0.4	0.5	(0.3)	(0.4)	0.4	0.6	(0.4)	(1.9)	0.6	0.2	(1.3)	(3.7)	1.4
INDICATORS OF INCOME AND EXPENDITURES																				
Interest margin to gross income	83.9	206.3	116.7	0.9	73.3	381.8	171.7	110.8	100.9	127.5	161.2	116.0	87.2	202.9	(197.8)	107.5	126.2	167.8	(222.3)	106.0
Non-interest expenditures to gross income	95.7	205.9	94.1	0.7	74.8	537.3	1,125	91.0	97.1	321.3	988.2	89.6	77.2	569.2	(1,423.0)	68.7	117.3	553.8	(1,892.6)	64.0
LIQUIDITY																				
Liquid assets to total assets	47.6	34.0	24.9	29.9	34.0	26.7	18.6	21.7	29.8	30.5	22.2	23.0	31.2	26.8	24.6	20.2	31.1	25.5	26.6	20.9
Liquid assets to short-term liabilities (up to one year)	72.3	68.4	33.0	48.6	40.1	37.6	22.4	25.7	35.7	44.3	26.1	26.8	38.1	39.4	29.4	23.7	40.0	39.1	33.6	26.1
Deposit/Loan ratio	197	107	91	140	190	94	91	134	202	114	107	149	189	105	114	136	187	110	125	124
NET OPEN FOREIGN CURRENCY POSITION TO CAPITAL																				
Net open foreign currency position to core capital	-2.1	21.1	-2.9	1.5	0.6	15.6	-1.7	6.8	-3.2	-1.1	-0.5	14.9	-3.3	-1.5	-2.4	7.2	-2.2	-3.6	-0.4	5.1
Net open foreign currency position to regulatory capital	-2.1	18.0	-2.9	1.1	0.6	12.4	-1.7	5.3	-3.1	-0.9	-0.4	12.1	-3.2	-1.3	-2.1	5.9	-2.1	-3.1	-0.4	4.0
Net open foreign currency position to shareholders' capital	-1.8	19.1	-2.6	1.4	0.5	14.2	-3.3	6.5	-2.9	-1.0	-0.8	13.8	-3.1	-1.3	-4.1	6.8	-2.1	-3.3	-0.7	4.8

Source: Bank of Albania